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Supreme Court of the United States

OCTOBER TERM, 1951

No. 158

THOMAS B. LILLY AND HELEN W. LILLY, PETITIONERS,

US.

COMMISSIONER OF INTERNAL REVENUE

ON WEST OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIBCUIT &

PETITION FOR CERTIOBARI FILED JUNE 29, 1951. CERTIORARI GRANTED OCTOBER 8, 1951.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1954

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THOMAS B. LILLY AND HELEN W. LILLY, PETITIONERS,

28

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS

FOR THE FOURTH CIRCUIT

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IN THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 6204

THOMAS B. LILY and HELEN W. LILLY, Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE, Respondent

On Petition for Review of a Decision of the Tax Court of the United States

Appendix to Petitioner's Brief

COMMISSIONER'S STATEMENT OF DISALLOWANCE

Deductions claimed in computing the net income from businesses conducted in the names of City Optical Company, Richmond Optical Company, and Duke Optical Company, representing amounts accrued for or paid to doctors have not been shown to constitute deductions allowable under the provisions of Section 23 of the Internal Revenue Code and are therefore disallowed. [Second paragraph of statement attached to Deficiency Notice to Thomas B. Lilly]

[Attached to Deficiency Notice to Thomas B. Lilly]

COMPUTATION OF INCOME FROM CITY OPTICAL C	COMPANY
1942	
Adjustments to Net Income	\
Income per return of Thomas B. Lilly	\$34,180.62
(a) "Trade Discounts" disal-	
lowed \$60,714.90 (b) Leasehold improvements disallowed 2,450.39 (c) Excessive depreciation disal-	•
lowed 543.33	
(d) Bad debt disallowed 3,082.83	•
	66,791.45
Income from City Optical Company adjusted	\$100,972,07
Explanation of Adjustments	
(a) Trade discounts deducted an return \$63,814.36 Trade discounts allowable 3,099.46	
Trade discounts disallowed . \$60,714.90	
(b) The cost of the following leasehold imp deducted in the return have been disallowed	
New store front \$ 1,278.94 Mezzanine floor and stairs 1,171.45	, 1
(Pate) 4 9 450 20	

(c) Excessive depreciation as computed below has been disallowed:
Depreciation claimed in return \$ 3,550.70 Allowable depreciation per Exhibit C 3,007.37 Excessive depreciation \$ 543.33
(d) Bad debt representing account of Duke Optical Company deducted in business schedule attached to return has been disallowed.
[fol. 3] Income per return, Form 1065, filed in the name "City Optical Co. & Richmond Optical Co." \$ 38,508.60
(a) Trade discounts disallowed \$61,601.95 (b) Capital expenditures disallowed 830.97
이 보다가 하고 하다 하나 하는 얼마면 나를 가는 것이 보고 있다. 그 사람들은 사람들은 사람들은 사람들은 사람들은 사람들은 사람들은 사람들은
Total \$100,941.52
Total \$100,941.52 Less: (c) Accounts payable adjustment \$ 32.36 (d) Additional depreciation allowable 206.11
Less: (c) Accounts payable adjustment \$ 32.36. (d) Additional depreciation allowable 206.11 238.47
Less: (c) Accounts payable adjustment \$ 32.36. (d) Additional depreciation allowable 206.11
Less: (c) Accounts payable adjustment \$ 32.36. (d) Additional depreciation allowable 206.11 238.47 Income adjusted \$100,703.05

and equipment deducted in the return in a	
of \$830.98 has been disallowed.	ta navabla
(c) To reduce income by adjustment of account control.	is payable
(d) To allow additional depreciation as follows:	
Allowable depreciation per	
Exhibit C. \$ 4,169.57	
Depreciation claimed in re-	
turn 0 3,963.46	
Additional depreciation allow-	d
able \$ -206.11	
1944	
Income per return filed in the name "City Opti-	
cal Company"	\$25,326:69
Add:	
(a) Income credited to proprie-	
tors investment account \$ 2,596.26	
[fol. 4] (b) Leasehold improve-	
ments disallowed 291.49	*
(c) Contributions eliminated 202.45	
(d) Trade discounts disallowed 60,021.65	
	63,111.85
Total	88,438.54
Less:	
(c) Additional depreciation al-	
lowable	
(f) Decrease in gain on sale of	
machine 57.10	
	340.82
	340.82
Income adjusted	\$ 88,097.72

6,614.16

\$ 9,007.46

Explanation of Adjustments ...

- (a) Various items credited to proprietor accounts restored to income.
- (b) Leasehold improvements deducted as an expense in the return have been disallowed.
- (c) Contributions in an amount of \$202.45 have been eliminated in computing income from this business.
- (d) Trade discounts deducted in re-**\$64.195.06** Trade discounts allowable. 4.173.41

Trade discounts disallowed ... \$60,021.65

EXHIBIT D

[Attached to Deficiency Notice to Thomas B. Lilly]

COMPUTATION OF INCOME FROM DUKE OPTICAL CO.

Adjustments to Net Income

Income from Duke Optical Company per return filed by Mrs. Helen W. Lilly \$ 2,393.30 Add:

(a) Excessive depreciation disal-45.29

Income adjusted

allowed
(b) Trade discounts disallowed 6,568,37

[fol. 5] Explanation of Adjustment	8
(a) Depreciation claimed in return \$ 29 Allowable depreciation per Ex-	94.81 19.52
Excessive depreciation disallowed \$	45.29
	58.87 None
Trade discounts disallowed \$ 6,5	68.87
Income from Duke Optical Company per refiled by Mrs. Helen W. Lilly Add:	eturn \$ 2,469.38
	42.02 98.35
	5,040.37
Total	\$ 7,509.75
Less:	le le
(c) Intangible tax	2.88 2.21
	5.09
Income adjusted	\$ 7,504.66

Explanation of Adjustments

(a) Adjustment of cash amount credited to proprietorship account restored to income.

(b) Trade discounts and allowances per return \$4,798.35
Trade discounts and allowances allowable None

Trade discounts and allowances disallowed \$4,798.35

Ifol. 61 THE ISSUE BEFORE THE TAX COURT

Taxpayers' allegations-

- 4. (d) The Commissioner has erroneously disallowed the deduction of trade discounts in the amount of \$57,062.45 in computing the net income of City Optical Company for \$1942.
 - (i) The Commissioner has erroneously disallowed the deduction of trade discounts in the amount of \$61,601.95 in comparing the net income of the partnership, City Optical Company, for 1943.
 - (k) The Commissioner has erroneously disallowed the deduction of \$6,568.87 in computing the net income of the Duke Optical Company for 1943.
 - (p). The Commissioner has erroneously disallowed the deduction of trade discounts in the amount of \$60,021.65 in computing the net income of the partnership of City Optical Company for 1944.
- (r) The Commissioner has erroneously disallowed the deduction of trade discounts in the amount of \$4,798.35 in computing the net income of the Duke Optical Company in 1944.

Commissioner's Answer-

"4. Denies that the Commissioner committed the errors alleged in subparagraphs (a) to (t) inclusive of paragraph 4."

[fol. 7] EXCERPTS FROM TESTIMONY

DIRECT EXAMINATION OF MR. LILLY

By Mr. THIGPEN:

(Tr. p. 39)* Q. Mr. Lilly, give your name and address and age for the record, please.

A. Thomas B. Lilly; age 56; address, Wilmington, North

Carolina.

Q. What business are you engaged in?

A: In the optical business.

Q. How long have you been engaged in this business?

A. Since the early 1920's; I went in business myself in 1922.

Q. Where?

A. In Wilmington, North Carolina.

Q. What business did you go into? .

A. The optical business.

O. Under what name?

A. City Optical Company.

(Tr. p. 40) Q. How long have you operated the City. Optical Company?

A. Since 1922.

Q. Did you ever have any branches of that business?

A. Yes.

[fol. 8] Q. Where?

A. In Fayetteville and Greensboro and Richmond.

Q. When were those branches established?

A. In Fayetteville it was established in 1936; Richmond in 1937; Greensboro in 1939.

[&]quot;(Tr. p. 'xx')" is in reference to the pages of the Official Report of Hearing at Greensboro, January 31, to February 3, 1949.

(Tr. p. 67) Q. Mr. Lilly, how long have you been engaged in this business of City Optical Company?

A. Since 1922.

(Tr. p. 68) Q. Will you please tell the Court about trade discounts allowed! Just explain in very clear language just how you knew about them and what you did about them.

A. I can tell you from experience in a simple way. In 1922 I opened an optical business in Wilmington, North Carolina. In that section prior to that time the various doctor examined eyes. They had to furnish their own

glasses. There was no shop to do the work for them.

I called on them and wanted to put in a shop and do that work for them. They said, "We would like to have a shop to do it but we buy the glasses from Baltimore, Atlanta, New York and such places and they send them to us by mail and we sell them and make a profit on them and we would have to give up the profit."

They realized that their time as physicians was mighty precious to use it as mechanics. We said, "Doctor, let us take that off your haids." And we said we would give

them'a trade discount and that is what we did.

(Tr. p. 68) Q. About how much did that trade discount amount to in percentage?

A. 33 and 1/3 percent.

Q. Suppose you outline to His Honor a typical case of a [fol. 9] patient bringing you a prescription and how the matter was handled.

A. All right. We will say Doctor X or any doctor (Tr. p. 69) examines a man's eyes." He always lets that patient go anywhere he wants to, but they recommended us I think because of our good work. If the patient brought us that job we made the glasses, fit them to the patient's face, had them adjusted for him after that, and did the mechanical work and we kept a memorandum of that and gave the doctor a third of it.

The Court: That is to say, if you charged the patient \$30 for the glasses, you gave the cloctor who sent the patient there a rebate of \$10 or you gave him \$10,

A. That is correct, yes, sir, and kept a memorandum of

that and paid him that,

By Mr. THIGPEN:

Q. Mr. Lilly, over the years were you in contact with the manufacturing optical business as a whole?

A. Oh, yes, yes, sir.

Q. Do you know anything of your own knowledge now of the extent of this practice you have just outlined?

A. Yes, it was general.

Q. How long had it been going on?

A. Well, I know it has been going on—I don't know how long when I started in. I started in 1942 [1922] and it was the practice then. How long it had been going on I wouldn't know.

Q. You would say it had been the custom prior to 1922

A. Oh yes. I remember doctors that I was familiar with

(Tr. p. 70) going way backe

[fol. 10] Q. How did you consider these trade discounts

allowed to doctors in your particular business?

A. I considered it was a trade discount that they were entitled to. In other words, we were handling their patients for them. They were their patients to begin with and we were taking that mechanical work off of them.

Q. You filled the prescription of a doctor for a pair of

glasses?

A. That is right. In other words, we acted as agents for them.

Q. What effect did this arrangement have on the business of the City Optical Company?

A. It was helpful, of course.

Q. How was it helpful?

A. It was helpful in that we did getswork and we were recommended by them.

Q. What effect did it have on your sales?

A. It increased them. There would not be sufficient sales without it.

- Q. You said a few minutes ago that you made a memorandum of the work done for a patient of a particular doctor.
 - A. That is right.

Q. Were these transactions reflected on the books of the City Optical Company?

(Tr. p. 71) A. Yes, firee, absolutely.

Q. How were these payments made to doctors?

A. They were made by check in most all cases and we paid them usually on the 10th of the month following the transaction.

Q. It would have been possible for some to have been paid in cash, would it not?

[fol. 11] A. A few were paid in each but almost all of them were paid by check.

(Tr. p. 72) Q. Mr. Lilly, I show you the partnership return of income of City Optical Company and Richmond Optical Company, and ask if your signature appears on that return.

A. Yes, it does.

The Court: For what period! Mr. Thigpen: For the year 1943.

By Mr. THIGPEN:

Q. I show you the schedule attached to that return and the self-inst you tell us what the first 2 items are there.

A. Merchandise sales is the first one.

Q. How much?

A. \$439,658.62

Q. What is next?

A. Sales discounts and allowance.

Q. How much?

A. \$66,187.58.

Q. What is the next entry on that return?

A. Net sales.

Mr. Thispen: The petitioner offers in evidence, if Your Honor please, the original partnership return of City (Tr. p. 73) Optical Company and Richmond Optical Company for the year 1943.

Mr. Maddox: Objected to on the grounds it is a self-serv-

ing declaration.

The Court: Overruled; exception; received.

[fol. 12] (The document referred to was marked and received in evidence as Petitioner's Exhibit No. 17.)

By Mr. THIGPEN:

Q. I show you the partnership return of income for the year 1944 of City Optical Company and ask if your signature appears on that return.

A. Yes, sir, it is on there.

Q. Is any other signature there?

A. Helen W. Lilly.

Q. I show you a schedule attacked to that return and ask you to please identify the first 2 items and tell us what they are.

A. The first is merchandise sales.

Q. What is the total ligure!

A? \$466,651.64.

Q. What is the next item?

A. Trade discounts and allowances.

Q. How much?

A. \$60,188.26.

Mr. Thigpen: Petitioner offers in evidence partnership return of City Optical Company for the year 1944 signed (Tr. p. 74) by Thomas B. Lilly and Helen W. Lilly.

Mr. Maddox: Same objection.

The Court: Same ruling; received; exception.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 18.)

The Court: That \$60,000 item and the \$66,000 item in the last received return as we recall—those figures being approximate and identified as trade discounts—are those sums [fol. 13] the sums which were paid in those respective years to the doctors under the arrangement you stated a moment ago?

The Witness: That is correct.

Mr. Thigpen: Maybe I can clarify that, Your Honor. They were accrued and in most cases paid within the year. The returns speak for themselves on an accrual basis.

By Mr. MADDOX:

Q. Mr. Lilly, I show you an individual income tax return for the year 1942 and ask if your signature is on that.

-0

A. Yes, sir, it is.

Q. I call your attention to a schedule attached to the return and ask that you tell us what the first three items are and the amounts.

A. The first item is merchandise sales, \$370,139.77.

Q. And the next item?

A. Collection on bad accounts charged off, \$6,543.95.

(Tr. p. 75) Q. The next item?

A. Sales discounts and allowances, \$63,815:36.

Mr. Thigpen: Petitioner offers in evidence this tax return for the year 1942.

Mr. Maddox: No objection.

The Court: Received.

(The document referred to was marked and received in svidence as Petitioner's Exhibit No. 19.)

[fol.-14] Cross-examination.

. By Mr. MADDOX;

(Tr. p. 78) Q. Now, Mr. Lilly, prior to 1922 what was your occupation?

A. I was an apprentice in optical work.

Q. Doing substantially the same work as an apprentice that you do now as an optical company?

A. It was learning to do the same thing.

Q. Can you be more specific? Just what did you dogrind lenses?

A. Ground lenses, that is right.

(Tr. p. 79) Q. And prior to 1922 how long had you engaged in that occupation?

A. I would say about 2 years, about 1920 when I started,

Q. And by 1922 would you say you had completed your apprenticeship?

A. I had a working knowledge. Of course, as time went on—when I got in business for myself I added to that knowledge but I knew enough to run a shop.

Q. Who did you serve your apprenticeship with?...

A. I started with Dan P. Galvin Optical Company in Tampa, Florida.

Q. Dan P. Galvin Optical Company?

A. He was in the optical business. It has been so long I am not sure about the style of the firm.

Q. Where was it located?

A. In Tampa, Florida.

Q. When did you go with him?

A. I don't remember those dates. I know this: I went in business in 1922 and I estimate approximately 2 years be[fol. 15] fore that I served an apprenticeship. I can't remember the exact dates. That was a long time ago.

Q. Did you start serving your apprenticeship with him?

A. Yes.

Q. Did you continue with him until 1922?

(Tr. p. 80) A. No, sir.

Q. How long were you with Galvin, a short time or a long time?

A. It was a short time at two different times. I was there

at Christmas—

Q. Then where did you go?

A. Smith & Mercer Optical Company. They are not in business any more.

Q. At that time where were they located?

A. I worked in Raleigh, North Carolina.

Q. Is there any reason you left Tampa and came to Raleigh?

A. I had in mind going into business in North Carolina.

I was looking up this way.

Q. Were you from North Carolina?

A. North Carolina is my home and I intended to go in business in North Carolina.

Q. After you went into business in 1922 you continued up to the present time?

A. Yes, sir, that is right.

Q. Were there other optical companies other than Smith & Mercer, located in North Carolina at that time that you went with!

A. Yes, sir, Globe Optical Company operated in Raleigh.

Q. Any others you know?

(Tr. p. 81) A. Southerland & Holmes in Charlotte. I [fol. 16] think Southerland was always in it. That firm name changed. We always think of it as Southerland. I

think one of his partners, Pruett, got drowned while swimming.

Q. And seeking employment with Smith & Mercer Optical Company did you contact others in the field for employment?

A. I don't remember that I did at that time.

Q. Were there any other optical companies in North Carolina about that time that you recall?

A. The ones I named—that is all I recall right now.

Those are the only ones that I recall.

Q. You stated that you opened a branch in Fayetteville in 1926.

A. That is right, yes, sir.

Q. Can you tell us the reason for opening the branch there?

A. Well, Fayetteville is a good town and I contacted the doctors there and got encouragement. I wanted to expand and do a larger job than I was doing. I went over there and contacted the doctors the same way that I did in Wilmington.

Q. Are your contacts for business usually with doctors?

A. Yes, sir, that is right.

Q. Commonly known as oculists?

A. Ophthalmologists, optometrists cometimes known as oculists.

(Tr. p. 82) Q. After you opened business in Wilmington in 1922 did you keep in contact with the doctors in Wilmington?

A. Yes!

Q. How many doctors were in Wilmington at that time? [fol. 17] When we speak of doctors we mean oculists, eye doctors.

A. The number varied. I would say offhand 6 or 8 at that time.

Q. Has the number of doctors increased from time to time in Wilmington? Did you contact them from time to time?

A. No, sir, there are not as many doctors there today as there were then.

Q. But if new ones came into the city did you contact them?

A. Oh, yes, sir, that is the first thing we do when a new one comes in.

Q. That is from 1922 on !

A. That is right.

Q. You say you opened the Greensboro branch in 1939!

A. That is right.

Q. Was there any particular reason for that?

A. The same reason as the others. I felt I wanted to do a bigger job and be of more service.

Q. Were there optical companies here in Greensboro in

1939 before you opened?

A. Yes, sir, American Optical Company was the chief one (Tr. p. 83) here.

Q. Before you opened the Greensboro branch did you

have any Greensboro business?

A. No, sir, I would say—I don't believe I had any, no, sir. It would be negligible anyway. I don't believe any.

Q. Is that also true with reference to Fayetteville?

A. No, sir, I sold them on the idea we could do a little [fol. 18] better work than anybody else and they shipped them to us and we would get them back.

(Tr. p. 113) Q. After you went into business in 1922 you have done that sort of thing right along, haven't you?

A. You mean call on the doctors

Q. Yes.

A. Yes siree, absolutely.

Q. When you call on a doctor what do you usually discuss with him?

A. I discuss that we can do just a little bit better work than anybody else, and when a job gets into City Optical; Company it is double-checked and goes out right.

Q. Is that the extent of your discussion with the doctor?

A. I wouldn't say that is the extent, no, sir.

Q. Tell me the rest of it. We would like to know.

A. Just what goes with selling our organization. It just the regular selling—

Q. Do you still contact doctors !bday?

A. Yes, sir.

Q. Have you done so recently?

A. Oh, yes.

Q. Was the contact any different on the recent occasion than it was throughout the years 1922 to the present time?

· A. Any different?

(Tr. p. 114) Q. Yes.

A. I would say it was different in that I knew them better. Your acquaintanceship certainly must mean something.

Q. Besides telling them how good you made the glasses [fol. 12] what else did you discuss with them? If you had an occasion recently you should be able to tell us.

A. We discussed the service of City Optical Company generally.

Q. Otherwise than telling them how good you make

glasses, what else? Anything else?

A. We tell them that we appreciate the business that comes from them and I think they like to be appreciated. That helps a lot.

Q. In what manner does the business come from hem?

A. I would say in a large number of cases a patient asks the doctor for a recommendation. The doctor never tells a patient where to carry the prescription. They can carry the prescription wherever they want to, but because of the good work they can recommend our place, especially if they ask for a recommendation.

In most cases you go to a doctor and say, "Where is a good place to get this filled," and they say, "Well, you can carry it wherever you want to but we have found the services satisfactory of this, that and the other optical company."

(Tr. p. 115) Q. Do you ask the doctor to recommend

your place of business?

A. I wouldn't say I have come out and done that I would not say in direct words, but we would like them to recommend us and we feel if we tell them what we have they are going to recommend us.

Q. You said in your direct examination that what you

gave the doctor was 33 and 1/3 percent?

A. Yes, sir.

Q. Is that the correct percentage?

A. That is what we usually gave them where we dispensed.

[fol. 20] Q. That is 33 and 1/3 percent of what you collect

from the patient?

A. That is right, that is usually what was done.

Q. Were there exceptions to the 33 and 1/3 percent?

A. Very few. I think in one or two branches they charged the doctor the wholesale price plus a fitting fee.

Q. I am talking about the percentage. Isn't it true that Doctors Taylor and Strickland—you gave them 5 percent?

A. No, sir.

Q. What did you give them?

A. One third.

Q. How did you pay Doctor Strickland and Doctor Taylor?

(Tr. p. 116) A. I think they were paid with cash, Mr. Maddox.

Q. Paid with cash?

A. Paid with cash.

Q. Do you know why?

A. They requested it.

Q. Did they give you any explanation? A. No. sir.

(Tr. p. 151) Q. Well, you testified yesterday to what you called "trade discounts allowed".

A. Yes, sir.

Q. Those are amounts that you accrued to doctors and paid to doctors?

A. That is right.

Q. Where did you get the designation of the item "trade discounts allowed"?

A. Where did I get the designation?

[fol. 21] Q. Yes. Why did you designate it "trade discounts allowed"?

A. It is a discount to the trade.

Q. Discounts to the trade?

A. Yes, sir, in other words, I just called it what it appeared to be in my mind.

Q. Did you select the designation?

A. I don't think so, Mr. Maddox. I don't even recall. It is a period of years that that has been used and I don't

recall. It is something that has been used so long I don't even recall of the term designating that.

Q. That is the name of the account in which the amounts

(Tr. p. 152) are recorded, isn't it?

A. Yes, sir, and not only the name but what I considered it, a discount to the trade.

Q. By "trade" you mean doctors?

A. Yes, sir, I reckon strictly speaking—in other words, we speak of the trade generally as people that we sell to, people that buy are usually spoken of as "the trade", as I understand it.

Q. But you didn't select that flame for the account?

A. I don't know.

Q. You don't know whether you did or not?

A. No, sir, I do not. That is so long ago-

The Court: He says he doesn't know. Let's go ahead.

By Mr. MADDOX:

Q. I refer you to your 1942 return, Exhibit 19, and the third item to which Mr. Thigpen called your attention. How is it designated there?

A. Sales Discounts and Allowances.

[fol. 22] Q. And referring to your 1943 return, Exhibit 17, the second item that Mr. Thigpen called your attention.

to, how is that designated?

A. The same way, and I imagine the bookkeeper in making it up—it would be the same thing, as I understand it. I never thought too much about names but just really what it was. (Tr. p. 158) It was synonymous, I would say.

Q. Exhibit 18, the second item that Mr. Thispen called

your attention to, how is that designated?

A. Trade Discounts and Allowances. I thought those were synonymous.

Q. They mean the same thing to you?

A. Yes, sir, they are synonymous, I would say. .

Q. Did they have any special significance to you?

A. Those names?

Q. The names of the accounts.

A. The only thing that has significance to me is the account itself and any name that would designate it—

Q. From whomedo you purchase your material such as

A. From different places. I get some from Continental Optical Company, Shuron Optical Company—

Q. Baysch & Lomb?

A. Yesa

Q. American Optical Company?

A. Almost nothing from American Optical Company.

Q. They give you trade discounts, do they?

A. I don't know if you call it a trade discount or not. We just buy at the price they quote us.

Q. You don't know whether it is a trade discount or not?

.Is that your answer?

(Tr. p. 154) A. In other words, we pay—they bill it to [fol. 23] us and we pay the flat billings, in most cases. • We have a cash discount. 2 percent cash discount.

Q. In your direct examination you stated that you acted as agent for the doctors.

A. That is really what it was.

Q. Tell me the circumstances under which that agency arose. How did it come about?

A. You mean back to the beginning?

Q. I want your understanding as to how you became

an agent for the doctors.

A. Well, back to the beginning—starting in 1942 [1922] when I first opened the City Optical Company in Wilmington, at that time there were not nearly so many optical houses as there are today. The doctors had to order their glasses.

They were ordered from various cities—a few places in the South and more in the North. They had to do their own fitting of the frames. They bought the glasses and

sold them at a profit.

They being professional men had to do a lot of mechanical work, bending frames and fitting to the face, and we would go to the factor and tell him that he being a professional man that time could be put to operations and surgery and treatments, and we would take it off their hands.

They said, "That would be nice, but we buy glasses and sell (Tr. p. 155) them at a profit," so we suggested "We will take it off your hands and give you a trade discount."

I don't know what we called it, but that is what it was.

That is pretty well the—

Q. Is that your explanation of how you became an agent?

[fol. 24] A. I would say so:

Q. And in response to my question, that is the best you can state?

A. As far as I can think now, that seems to me to cover it.

Q. That is your explanation?

A. That is right.

Direct examination of Dr. J. D. FREEMAN.

By Mr. THIGPEN:

(Tr. p. 161) Q. What is your age, Dr. Freeman? (Tr. p. 162) A. Sixty one.

Q. What profession are you engaged in?

A. Eye, ear nose and throat.

Q. Outline briefly your medical training.

A. High school and University of North Carolina, and Medical College of Virginia, and post-graduate course in New York.

Q. When were you admitted to the practice of medicine?

A. 1918.

Q. Was that general practice or specialized practice?

A. General practice.

Q. When did you engage in specialized practice?

A. 1921.

Q. What was that specialized practice?

A. Eye, ear, nose and throat.

Q. What professional societies are you a member of?

A. New Hanover Medical Society; District Medical Society; Southern Medical Society; North Carolina Medical Society; Eye, Ear, Nose and Throat Society of North Carolina, and A. M. A.

[fol. 25] Q. What is A. M. A.?

A. American Medical Association; and I also belong to the Academy of Eye, Ear, Nose and Throat, a British organization, foreign organization.

Q. Are there any other professional societies that you (Tr. p. 163) are a member of that you have not already named?

A. I belong to the Academy of the Foreign Medical Society.

· Q. How long have you practiced as an eye specialist?

A. I started in 1941 [1921].

Q. How long have you known Thomas B. Lilly?

A. Since around 1922.

Q. What business is he engaged in?

A. City Optical Company...

Q. Dr. Freeman, I show you this paper and ask you to look at both sides of it and tell me if your signature appears thereon at any place.

A. On the front and endorsed on the back, J. D. Freeman.

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Q. That is your signature?

A. Yes, sir.

Mr. Thigpen: The petitioner offers this check as an exhibit for identification at this time.

Mr. Maddox: No objection for identification.

The Court: Let the check be marked for identification as the next numbered exhibit of the petitioner, for identification.

for Identification.) *** Exhibit No. 22

[fol. 26] By Mr. Thigpen:

Q. Now, Dr. Freeman, for what was this check paid to you?

(Tr. p. 164) A. For professional services rendered to my patients at City Optical.

Q. What is the date on that check?

A. January 10, 1944. 🧈 🕈

Q. What does that check represent?

A. Trade discount.

Q. For what period of time?

A. January, 1944.

Q. Now, Mr. Freeman, will you explain to His Honorthis term "trade discounts allowed" that you have used in connection with that check? Tell us just what that represented?

A. Patients come into the office for examination of the eyes. Legive them an examination and write a prescrip-

tion to the glasses and they take them to the City Optical

Company and get it filled.

I always advise the patients to come back to my office for reexamination of I can check the lenses and see that they are perfect in every respect. If they are not I referthem back to the City Optical Company for correction.

Q. Do you recommend the City Optical Company to your

patients, or do they just go there?

A. Well, I recommend them.

Q. Why!

A. Because they get excellent service. They don't have to go. They can go to other places, but if they go to the City (Tr. p. 165) Optical Company I feel like my patients get excellent service.

Q. Well, now, what sort of an arrangement did you have [fol. 27] with the City Optical Company that prompted them to send you this check for \$629.15? We will use this as an illustration.

A. Well, the patients would go there and get the classes [glasses] and come back to me for reexamination and maybe in a month the glasses don't fit, they are out of line, and they come to me again.

I recheck them—it doesn't cost them anything at all and I send them to City Optical Company for readjustment and the City Optical Company does not charge them

anything.

Q. I wear glasses. Suppose I came to you and you examined my eyes and you gave me a prescription and I took it to City Optical Comapny. From there on what happens with regard to my relations with City Optical Company. Who do I pay for the glasses?

A. City Optical Company and I am responsible for the

glasses.

Q. Then what happens to the sum of money I pay the City Optical Company?

A. They give me one-third off the glasses.

Q. They give you one-third of what I pay to them for the glasses?

A. Yes.

Q. How long has this arrangement been in effect! (Tr. p. 616) A. Since 1922.

Q. Do you know of any similar arrangement with any other manufacturing opticians?

A. No.

Q. How do you consider the trade discounts that you received as, for instance, this check?

A. I thought it was fair and square as the patient certainly got the service for that.

[fol. 28] Q. And what did you do with the money?

A. I added it on my daily—They paid it on the 10th. I but it in my daily cash book as January 10, 1944.

Q. You mean February 10 or whenever the check was

A. Yes.

Q. You entered it on your cash book as what?

A. Check received from the City Optical Company of so much. That goes with the other daily receipts and every day that is added up and shows — much I received that day.

Q. How much you received that day from all sources?

A. How much I received that day from all sources.

Q. How did you treat this trade discount allowance for tax purposes?

A. That goes into the regular receipts, received by the

year.

Q. So it was included in your regular income tax?

(Tr. p. 167) A. Oh, I paid income tax on it.

Q. You know any public policy that your receipt of these trade discounts violates?

A. None whatsoever.

Q. Do you know of any ethics of the Medical Society that it violates?

A. No, none whatsoever.

Cross-examination of Dr. J. D. FREEMAN.

By Mr. Maddox:

Q. Exhibit 22 as to which you have identified your signature—that was one of a number of checks you received in that year, was it not?

[fol. 29] A. Yes, I received one of these every month.

Q. You have received one of these every month for how many years?

A. Since 1922.

Q. Up to the present time?

A. Up to the present time.

Q. Do you still receive those?

A. Yes: sir.

Q. Does this amount represent approximately what you have been receiving monthly?

(Tr. p. 168) A. It varies considerably.

Q. From what to what?

A. When A first started, to be honest with you, it was around about \$40 or \$50 a month. As my practice increased the checks increased. As my patients increased the checks increased.

Now, Dr. Freeman, a patient comes to you for exam-

A. Yes.

Q. You are known as an oculist?

A. Eye, ear, nose and throat. I do all of that.

(Tr. p. 169) Q. And does anyone send the patient to you?

A. Oh, yes.

Q. Does the optical company?

A. No.

Q. And you examine the eyes?

A. Yes, sir.

Q. And you make a charge for that examination?

A. Yes.

Q. Now, in each — where you examine a patient's eyes, do you recommend the City Optical Company? [fol. 30] A. I said they can go to the City Optical Company.

Q. I beg your pardon?

A. I tell them they can go to the City Optical Company.

Q. You don't recommend them?

A. Oh, yes, I recommend City Optical Company.

.Q. What do you say to the patient?

A. I say, "You can take this to the City Optical Company," and if they don't want to take it there I say "Take it anywhere you like."

Q. Do you urge them to go?

A. Oh, no.

Q. You said you consider this as a trade discount. What am I to understand by that term "trade discount"? What is in your mind?

A. I consider it a service I render the patient. They (Tr. p. 170) come back for re-examination off, and on, and I don't make any charge. If the glasses need adjustment the City Optical Company does that free of charge. That saves me lots of time in fitting the frames and readjusting.

Q. What does the re-examination consist of ?

A. Some of them I give a complete examination again.

Q. What is the reason for that?.

A. They say the glasses don't fit. The don't see as good as they should.

Q: What is, the fault of that? Why can they see good?

A. Sometimes the glasse's are crooked like that (indicating).

Q. You have to make a complete examination to determine that?

A. I test the lens, to see if it fits the prescription I [fol. 31] wrote, and I give a complete examination and see that the glasses are all right.

Q. Do you always give a complete examination when

they come back?

A. If it is a kid you have to put drops in the eyes. I do not do that all the time. You might call it a superficial examination, put the lens on and try those and put the old lens on and I see that the lens checks up correctly.

Q. Do you in each case make a re-examination? Is that what I am to understand?

(Tr. p. 171) A. I test them out, yes.

Q. Does that consist only of putting the glasses on the eyes and looking at them? You don't examine—you don't re-examine the eyes, do you?

A. That is re-examining the eyes.

Q. What do you do on the first examination?

A. The first examination I take the vision, then I make a manifest test, and put the lens on. Then I put the drops in the eyes, dilate the pupils and examine through a retinoscope and ophthalmoscope and fit the glasses.

Q. Anything else?

A. I fit the glasses and then my prescription.

Q. Do you do that again on your re-examination?

A. Not all of it.

Q. What do you lo on re-examination?

A. If it is an elderly patient I first check the lens to see that they are what I ordered. If they are what I ordered I put the trial frame on and put the lens on exactly like I had them for the first examination. If they prove correct I say the lens only needs adjusting. It is out of line. Sometimes it takes 10 or 15 minutes, no longer than that.

[fol. 32] Q. If the patient is not elderly, what do you do?

A. If the patient is not elderly I give a complete exam-

ination.

Q. If the patient is not elderly?

(Tr. p. 172) A. I have to give a thorough examination again.

Q. What is the reason for that?

A. The mother says the kid can't see, headaches or something like that:

Q. How many of the patients are children?

A. I can't tell you that; I can't possibly tell that.

Q. Now, as a matter of fact, Dr. Freeman, most of the re-examinations consist of—in most of your examinations there is nothing wrong with the glasses at all?

A. Some. In some I make mistakes.

Q. In most you don't?

A. In some I have to change prescriptions entirely. If I change the prescription entirely I send the new prescription to the City Optical Company and I make no charge and they don't.

Q. Whose fault is it when you have to do that?

A. Some are my fault.

Q. And that is rare?

(Tr. p. 173) A. That is rather rare. We all make mistakes; I make mistakes.

Q. And in a great number of cases it is just a small mechanical adjustment that is necessary. Isn't that true?

A. That is true.

Q. And you just discover that. You don't correct it

yourself, do you?

A. No, I do not. If it is in the frame I don't correct it. City Optical Company does that.

[fol. 33] Q. You just discover it and send it back?

A. Yes.

Q. These occasions, are they numerous where the frame does not fit?

A. Some people are not hard to fit.

Q. You are not answering the question. The question is:

A. Several a week. I don't know if it is numerous.

Q. Approximately how many patients do you have a week so we can determine if they are numerous or not? Can you state that?

A. I cannot tell you how many patients I have a week.

I can look at my books and tell you.

Q. You cannot without looking at your books?

A. No, sir. I can't determine how many patients I have a day.

(Tr. p. 174) Q You said the City Optical Company gives you one-third. One-third of what?

A. One-third of the whole collection.

Q. From whom?

A. From the patient.

Q. And how was that third determined?

A. If they collected \$100, one-third of \$100.

Q. How did you arrive at one-third?

A. We thought that that would be about right for the services they rendered.

Q. How did you arrive at one-third as the right amount you would receive of the patient's charge?

A. That has been customary. That is the only thing I

know.

Q. Just a matter of custom. Was anything else back of that one-third?

A. No, sir.

[fol. 34] Q. Now, you said you have no knowledge that receiving this one-third was against public policy. Have you ever heard or read anything with reference to it?

A. As to the ethics?

Q. Have you ever read or heard anything with reference

to this practice of a third going from the optical company to the doctor who made the examination?

A. Right recently I have.

(Tr. p. 175) Q. Where did you hear that or where did you read it?

A. In the paper.

Q. Can you tell us where you were acquainted with it or where you heard it or read it?

A. I read it in the papers. Our papers have it in

Wilmington and the Greensboro paper.

Q. Has it ever been brought up in the American Medical Association meetings?

A. Yes, brought up at the last meeting.

Q. How many times do you recall it being brought up?

A. One time.

Q. Just once?

A. Yes, sir.

Q. With those qualifications, then your statement that you know of no public policy or anything against medical ethics—is that the way I am to understand your statement?

A. Yes, sir.

Q. In other words, you are acquainted with a discussion of the matter through newspapers and through discussions in the American Medical Association? Is that right?

A. That is right.

[fol. 35]

Redirect examination of Dr. J. D. Freeman.

By Mr. Thigpen:

(Tr. p. 176) Q. And the newspaper accounts and the discussions in the American Medical Association, there has been no definite ruling by the Association in the matter of these trade discounts, has there?

A. No, sir.

The Court: Are there any of your patients who take your prescriptions to a company other than the City Optical Company?

The Witness: Yes, sir.

The Court: In those instances, what happens?

The Witness: I have to measure the frames and send them to where they want, and if they go to Wilmington or Greensboro or Raleigh or different places they send the glasses directly to the patient.

The Court: Is your treatment of the patient different

in those eases?

The Witness: No, sir, none whatsoever.

The Court: Another question I would like to ask you.

When you examine a patient and complete that examination and give him or her a prescription, you charge the patient a fee for that. Is that so?

The Witness: That is correct.

The Court: Now, when they take that prescription, you [fol. 36] recommend that they take that prescription to the City (Tr. p. 177) Optical Company to be filled?

The Witness: That is right, sir.

The Court: When they take that to the City Optical Company and it is filled, the City Optical Company pays you one-third of what the City Optical Company receives from your patient?

The Witness: That is right.

The Court: When you recommend that your patient go to the City Optical Company to have your prescription filled, do you tell, or does the patient know, that you are to receive one-third of what the patient pays the City Optical Company for that service?

The Witness: Some do and some do not. If they ask

me I tell them. If they don't ask me, I don't.

The Court: About what proportion ask you?

The Witness: Very few.

Direct examination of Dr. S. E. Koonce.

By Mr. Thigpen:

(Tr. p. 178) Q. Where do you live, Dr. Koonce?

A. Wilmington, North Carolina, 1709 Princess Street.

Q. How old are you, Doctor?

A. I was born on the 14th of May, 6 o'clock, 1870, according to my mother's Bible.

Q. What is your profession, Doctor?

A. After I graduated at Trinity College which was [fol. 37] then in Randolph County and then moved to Durham, I taught for 3 years.

Then I studied medicine and graduated in 1896.

Q. When were you admitted to the practice of medicine?

A. 1896.

Q. Was that general practice?

A. Yes.

Q. When did you specialize or limit your practice in a special field?

A. I went to the post-graduate in New York in 1907 and began practicing eye, ear, nose and throat in 1908.

Q. And you have been practicing continuously since that (Tr. p. 179) time.

A. Until last April.

Q. What happened last April?

A. Quit.

Q. Retired?

A. Yes, sir.

Q. Doctor, what professional societies have you been a member of or are you now a member of?

A. The American, the State and the local.

Q. How long did you practice as an eye doctor?

A. From 1908 to the first of April, 1948.

Q. How long have you known T. B. Lilly?

A. Ever since he has been in Wilmington. I knew his brother who practiced eye work in Fayetteville before that. He referred me a case or two.

Q. About when did Mr. Lilly come to Wilmington?

A. I couldn't answer that question unless I would take my prescription books and look at them, and I haven't got them here.

Q. That was a good many years ago? [fol. 38] A. Yes, sir, you know that.

Q. Dr. Koonce, what arrangements, if any, did you have with the City Optical Company with regard to what we call a trade discount allowed?

A. Well, just at the end of the month there is a certain (Tr. p. 180) percent that whenever I gave a prescription—since he has been in Wilmington—because it was much quicker and he was the only manufacturing optician there,

the only man that did surface work—the ordinary opticians couldn't surface the glass and he is the only man who

could do surfacing work.

The first firm I ever dealt with was F. A. Hardy in New York, the second I believe was D. V. Brown in Philadelphia, and I got it quicker, and then I used S. Gillespie in Richmond and Norfolk and a firm in Columbia, South Carolina.

. Q. When you sent those prescriptions off and they manufactured the glasses, what did they charge you for the

glasses?

A. They had a prescribed price and we had that price

list.

Q. Was that prescribed price that you actually paid to the manufacturer, the same as the price that you charged the patient retail for those glasses?

A. No, that has never been the custom.

Q. There was a difference?

A. There was a difference, yes.

Q. Dr. Koonce, I wear glasses. Suppose I came to you and had you examine my eyes. Explain to His Honor just what would take place with regard to the prescription?

A: Well, on account of the City Optical Company being in Wilmington, the majority asked me "Where shall I [fol. 39] take this (Tr. p. 181) prescription," and I tell them to the Optical Company. Some will tell me "I am going to Raleigh. Can't I take the prescription there," and I tell them "Y's," and I have had one or two tell me they were going to Richmond or Norfolk and take the prescription there if they want.

Q. So if the patient gets your prescription and takes it to the City Optical Company, and the City Optical Company,

manufactures the glasses, then what takes place?

A. The City Optical Company collects the prescription price of the glasses just like the other people had a prescription price.

Q. Then after the City Optical Company collects the prescription price, did you ever receive any portion of it?

A. Yes, at the end of every month.

Q. What did you receive, what portion?

A. About one-third, I think.

Q. What has been your experience in dealing with the City Optical Company?

A. Why the owner of that is one of the finest men and the fairest men, gives the fairest treatment to both the physician and the patient, that I ever had any dealings with. If there was any correction I always instructed my patients, and I think that was customary and would account for any fund that we received—my advice would be come back and let me check that prescription and see that it was right.

(Tr. p. 182) Q. When you received these remittances from City Optical Company each month, based on your

memorandum, what did you do with the remittance?

A. Deposited it.

Q. And treated it on your books and records as what?

[fol. 40] A private account.

Q. What do you mean by "a private account"?

A. Deposits in the bank.

Q. Deposits in the bank. Was that deposit included in your income?

A. Yes, sir.

Q. Treated just like any other money you received?

A. Yes, just like a cataract extraction or a mastoid opera-

Q. Did you ever receive any trade discounts from any

other firms than City Optical Company?

A. There was a prescription price and a wholesale price, just like these people have, no different.

Q. Doctor, do you know of any public policy that the

receipt of these trade discounts by you violated?

A. No, sir.

Q. Do you know of any professional ethics in the medical profession that were violated by your receipt of these trade discounts?

A. I didn't consider it so.

(Tr. p. 183) Q. Do you know of any announced ethics by the Medical Society—

A. Those things have been discussed by the Medical Asso-

ciation.

Q. But to your knowledge has there ever been any prohibition against the receipt of these?

A. No, sir.

Cross-examination of Dr. S. E. Koonce.

By Mr. Maddox:

Q. Dr. Koonce, I understand from you when you say "prescription price," you mean the price that the patient pays for the completed glasses. Is that what I understand?

[fol. 41] A, Well, since the manufacturing optician has been in Wilmington, I didn't collect it, but when the prescription had to be returned to me from New York or Baltimore or Richmond or Columbia or Norfolk, I had to collect it then and I collected it from the patient, what was considered a normal prescription price.

Q. How was that ascertained?

A. In Wilmington I have never collected it. The City.

Optical Company collected it.

Q. Prior to your arrangement with City Optical Company, how did you determine the prescription price that you charged for the glasses?

(Tr. p. 184). A. I didn't determine it. He had a catalogue price and he used the same price. I had a catalogue price on what it was and it was in accord with that. So much for the compound lens, so much for the simple hyperopia or myopia, according to the strength of the lens.

. Q. They were listed in a catalogue?

A. We had price lists. You could call it a catalogue or whatever you want to.

Q. You had a catalogue yourself?

A. I had for all those other companies and others we estimated.

Q. When you say "all those other conmanies"___

A. I don't know if I ever had one of them or hot.

Q. By "them", meaning City Optical Company?

A. I think I had one. I am not sure. I would have to ask Mr. Lilly about that.

Q. What do you mean by the "other companies"?

A. F. A. Hardy, D. V. Brown of Philadelphia-

Q. Those you enumerated in your direct examination?

A. I had to order them in 1908, as I stated, because there [fol. 42] was no manufacturing optician close to us, there was none in the State. The closest was Richmond and Norfolk.

Q. For the examination of the patient's eyes you collected a fee?

A. Yes, sir, a fee for the examination and the other part (Tr. p. 185) that we got I always considered paid for the checking and examination of the glasses and then whenever the glasses came the City Optical Company—if the patient brought it to another place that firm always sent about the same discount that the City Optical Company or I would get at the end of the month. When there wasn't any firm in Wilmington I would collect it and send it to the companies at the end of the month.

Q. Were there ever any optical companies in Wilmington

aside from the City Optical Company?

A. Never before—never been a manufacturing company except the City Optical Company in Wilmington. Nobody ever had a surfacing machine. One or two men there did edging, but a compound prescription they can't edge. They can't keep a stock.

If you have a compound lens that would mean they couldn't do that and they would have to send it to the City Optical Company or down to some distant firm to have these

lenses surfaced.

Most of them did have an edging machine but, for instance, if you had a plus one or a minus one lens they have a machine that would edge it to fit a certain size frame.

Q. Getting back to the prescription price, that is the amount that the patient pays for the finished glasses, isn't it, Dr. Koonce?

A. It is what the patient paid, yes, sir. It has always [fol. 43] (Tr. p. 186) been about the same for all optical companies.

Q. And the third that you got of that prescription

A. Excuse me just a minute. The practicing opticians who are not doctors or eptometrists—there is no rule but they usually added a fee into the prescription price. That is my understanding. I couldn't swear to that but that is what I have always heard.

Q. The third you got was one-third of the prescription price, wasn't it?

A. I think so. For the last few years at any rate that

is so. I didn't estimate it. I would look over the names of the patients and that would be about all.

Q. Now, this amount that you received each month or have received each month, representing one-third of the prescription price paid by patients that went to optical companies, is what you have termed "trade discounts"!

A. Yes, or service discounts, whichever you want to call

it. There is an exception to that.

Q. When the patient got the glasses in each case did they return to you after getting the glasses?

(Tr. p. 187) A. That was my advice.

Q. What did you do after they returned?

A. I check the center of the glasses and the fitting of the frames, to see if they were comfortable and had a proper pupillary distance.

Q. Was that all you did?

A. With the exception of charitable cases. I never received a fee and the City Optical Company always had a [fol. 44] very small fee cost for the glasses, less than their own fee. We had to get a permit from the Board of Charities and they would order it and I never charged anything and they charged a very small amount for the glasses—not over the cost to them of the actual material.

Q. You mean a very small cost to the patient?

A. A very small cost to the patient, none to the doctor. A very small cost for the glasses and that was not included in our monthly statement—nothing but private or pay patients.

Q. And some fee came from the State, Did the State pay any part of the cost of the charity patients?

A. The Board of Health paid for the glasses of charity patients.

Q. You made a statement that you know of no public policy which contravenes this practice. Have you read anything about public policy on the subject?

A. I have read a lot of Articles about that but nothing

(Tr. p. 188) I could say is definite.

Q. Have you ever heard discussions on the subject?

A. I have heard of discussions.

· Direct examination of Dr. Paul Black.

By Mr. Thigpen:

Q. Dr. Black, give us your address.

. A. 218 North Fifth, Wilmington.

Q. How old are you?

A. I am 42.

Q. What profession are you engaged in?

A. The practice of eye, ear, nose and throat.

Q. Will you outline briefly to His Honor your medical-(Tr. p. 189) training.

[fol. 45] A. I finished medical school in 1933 which, was end of my internship. From there I went to Long Island Hospital, Boston, Massachusetts for a year and a half. Then I spent a year at the Hinsdale Sanitorium and Hospital in the suburbs of Chicago in eye, ear, nose and throat, and also Chicago Eye and Ear Infirmary, and then Battle Creek Hospital, and was head of the Eye, Ear, Nose and Throat Division for a year and a half.

Q. What college did you attend?

A. College of Medical Evangelists in Louisiana.

Q. When were you admitted to the practice of medicine?

A. 1933, when I finished my internship. I took the State Board of Maine.

Q. When did you come to North Carolina?

A. The first time I came was in 1937.

Q. When you came to North Carolina in 1937 where did you locate?

A. Wilmington, North Carolina.

Q. Were you engaged in general practice? ...

A. For a short time, about two and a half years.

Q. Then what did you do?

A. I went in the Army at the end of 1940.

Q. At the end of 1940 you went into the Army?

A. That is right.

(Tr. p. 190) Q. Did you do any specialized practice before you went into the Army?

A. I did.

Q. What was that?

A. Eye, ear, nose and throat.

Q. How long were you in the Army?

A. Five and a third years.

Q. After you get out of the Army, what did you do? [fol. 46] A. I went into eye, ear, nose and throat.

Q. Where!

A. Wilmington; North Carolina.

Q. And you have practiced eye, ear, nose and throat work continuously since?

A. Yes, sir.

Q. How long have you known Thomas B. Lilly.

A. I Believe 1938.

Q. What business is he engaged in?

A. In the manufacture of optical supplies, glasses.

Q. Do you know the name of the company?

A. City Optical in Wilmington.

Q. Dr. Black, one of the issues in this case has to deal with what we have termed trade-discounts allowed. Do you know anything about trade discounts allowed to doctors.

A. Yel, sir.

Q. Did you ever receive any trade discounts?

(Tr. p. 191) A. Yes, sir.

Q. Will you explain to His Honor briefly your under-

standing of this trade discount allowance?

A. Sir, that is money that is returned by the optical company or wherever the purchase of glasses is from for services rendered the patient during that period of time for the

fitting and checking of that patient.

Q. Suppose you give us an illustration. I wear glasses. Suppose I came to you and asked you to examine my eyes and you gave me a prescription and I had it filled and paid for the glasses, and so on. Take a hypothetical case and tell His Honor what would happen in the matter of payment for those glasses and what would you receive as a trade discount?

A. The patient is given a prescription. They are not [fol. 47] directed to go to any individual. Of course in Wilmington only one company makes glasses and that individual necessarily has to buy their glasses from somebody that gets their glasses from the City Optical.

They can take it to any individual they want to have the prescription filled. There is only one place that makes glasses in that community.

Q. As an illustration, if I took the prescription to the

City Optical Company and they filled the prescription,

what would they do?

A. Of course, they fit the patient and the patient pays (Tr. p. 192) them. At the end of the month the number of patients you have the doctor receives one-third of the total charge.

Q. Of the total charge to the patient?

A. The total the patient pays.

Q. Suppose I went in and got my pair of glasses and walked out and didn't pay the City Optical Company?

A. There would not be any money received by either

the City Optical Company or by the doctor.

Q. By either City Optical or by you. Is that right?

A. Yes, sir.

Q. What has been your experience with the City Optical

Company, Dr. Black, in this connection?

A. I have dispensed glasses and L of course, have dealt with the City Optical Company. I have dispensed glasses with other firms and that means the purchase of the glasses at wholesale price and sold them at retail price. I think that the patient gets much better service when they can go to a place where trained personnel can look after the prescription, fit and adjust, and look after that individual, than if they came to me.

[fol. 48]. Q. And this arrangement with the City Optical Company has been very satisfactory, has it?

A. Highly satisfactory, better than any group that

I know of as far as so vice to the patient.

Q. Dr. Black, do you know of any law or public policy (Tr. p. 193) that the receipt by you of such a trade thiscount violates?

A. I do not, no, sir.

Q. Do you know of any provision of the Medical Code of Ethics that the receipt of such trade discount violates?

A. No, sir.

Cross-examination of Dr. Paul Black.

By Mr. Maddox :

Q. Now, Do. Black, for examining the patient's eyes you charge a fee, do you not?

A. Yes, sir.

Q. What is that fee for?

A. For fitting the patient with glasses.

Q. I am speaking about the fee you charge the patient.

A. That is for examining and fitting the patient—examining the patient's eyes and fitting him with glasses.

Q. Now, how does it happen that you get a third of what.
Mr. Lilly charges your patient for the glasses he has made for the patient! How does that happen to be a third!

A. I think probably that is taken as the amount that it probably costs to carry the patient over the period of time, as far as the glasses are concerned.

Q. I don't understand that statement.

[fol. 49] A. Allow me to explain. The patient is examined and given a prescription. He takes it to the City Optical.

(Tr. p. 194) The City Optical fits that individual with frames and makes the glasses. The patient goes back and gets the glasses and they are adjusted on the patient's face.

Now, they come back as a rule—they don't all come back—but as a rule they come back to the doctor and the doctor re-examines them and sees that the glasses are all right and that their vision is all right with the glasses and that everything is satisfactory. If they are not pleased with the glasses and they are not correct, we have an understanding that we will re-examine them and give them a new prescription as many times as is necessary.

Of course, doctors make mistakes, as everyone else does. If we should make a mistake we give the patient another prescription and he gets the new lenses at no cost to him.

That takes time from the doctor.

The patient comes back in a month or two weeks or three weeks, and says, "Doc, these glasses don't fit," and you see that the glasses are out of adjustment, something is wrong with them, and you send it back to City Optical and they correct that.

* They give that service but the doctor has to take up his time to check on that. There is no charge made by the doctor to check and see them.

Q. When the patient comes backeto you what do you do?

A. Re-examine him.

(Tr. p. 195) Q. That is a general term. I want specifically just what you do.

A. Sometimes it includes a complete eye examination and [fol. 50] sometimes it is not a complete examination.

Q. In what instances does it entail a complete examina-

tion?

A. In what instances?

Q. Yes,

A. Sif, if the patient complained that the sidewalk appeared crooked to him, or if they said their vision in one eye was blurred and they couldn't see out of that lens, and you gave him a superficial examination and still it appeared you had to re-examine him you might put drops in the eyes again and give him another examination.

Q. Is that a case where the doctor made a mistake? Is

that what I understand?

A. Sometimes that is true.

Q. How often do you have to make a complete re-

A. Sometimes it comes kind of often.

Q. I beg your pardon?

A. Sometimes it comes kind of often; sometimes we don't have to do but once a month, and maybe it will be five or six months, and maybe there won't be any during the month. It is hard for me to tell how many times.

(Tr. p. 196) Q. You haven't any idea?

A. The percentage I wouldn't say. I could guess but I might be wrong.

Q. You have been practicing how many years?

A. Since 1933, but I have never added up the number.

Q. Are there many compared with the total number of

patients you have treated?

A. I think that number varies according to how many patients you have to take care of. I think if you examined [fol. 51] a great many your errors would be more.

Q. Over the period of time you have been practicing

would you say it has been many or few.

A. I think that is few. I think that is because I try to exercise a good deal of care.

Q. And most of the patients come back and the glasses

are correct, aren't they?

A. Yes, sir, they are. I would like to say this, if it is all light: In some individuals you can make four or five pairs before you find a pair that will satisfy them.

Q. How many individuals have you done that for?

A. Since I got out of the Army I expect I have had at least 30 and maybe 50.

Q. What is the reeson for it?

A. Well, various reasons.

Q. Let's have some of them, the main ones.

(Tr. p. 197) A. There can be muscular unbalances, differences of prescriptions of one lens over another. For instance, a patient who is nearsighted in one eye and farsighted in the other eye—it is difficult to balance their eyes and sometimes I think it is due to the individual being a nervous type of individual, and I have some people who when they walked in you knew you had to make two or three pairs of glasses for them.

Q. You mean their eyes changed from day to day?

A. With some individuals it is change and with some it is the individual himself, and some are not satisfied until they have had three or four pairs made.

Qo That is quite general in the practice?

A. I think ery doctor has that.

Q. I mean in your practice.

A. It is not the usual thing, no, sir.

Q. You say you have had 30 or 40 in your experience? [fol. 52] A. I think I have had that many since I came out of the Army.

Q. Since 1933?

A. Since 1945.

Q. You specialized in eye, ear, nose and throat in 1937

before you went in the Army?

A. And I did it while I was in the Army, and I might add during the time I was in the Army I was Chief of the Eye, Ear, Nose and Throat Sections in a 2700-bed hospital and we fitted (Tr. p. 198) dwenty—to thirty—thousand pairs of glasses.

Q. Did you have the same experience in the Army?

A. It is not as bad in civilian life as it is in the Army.

Q .- How many did you have in the Army?

A. It was according to the morale of the particular regiment or group.

Q. I am not asking the cause. I am asking the number.

A. I think it was higher in the Army, perhaps ten or fifteen percent higher.

Q. And you can't give it in numbers. You could just give it in percentages?

A. I couldn't give it in numbers.

Q. How many patients did you have while you were in private practice. You estimated what you had in the Army.

A. I had exact records in the Army because we had to give reports.

Q. Don't you make exact records?

A. Yes, sir.

Q. Don't you have any recollection as to the number of pat-ents!

A. I think I could figure it up.

[fol. 53] Q. It means nothing unless you give some additional facts.

A. I expect I see between 200 to 300 patients a month. (Tr. p. 199) That is not all eye work, however, not all glasses, not all refractions and fitting of glasses.

Q. How many were for glasses!

A. I think 35 percent of that number.

Q. Now a goodly number of the patients never return to you for re-examination, do thous?

A. Still on a percentage basis I would say that between

50 and 60 percent do not return.

Q. And in those cases do you still get the third of the price charged that patient?

A. Yes, sir.

Q. When you talked about trade discount, you meant the third of the purchase price the patient paid for glasses that we remitted to you at the end of each month?

A. Yes, sir, that is right.

Q. Now, you say you know of no public policy against the practice.

A. I know of no law or public policy, no sir.

Q. Have you ever read any articles discussing the question, the general question?

A. Yes, sir.

Q. Have you ever heard discussions of the general question about these payments of one-third of the patient's charge for the glasses to the doctor?

A. May I ask what you mean by "discussion"?

(Tr. p. 200) Q. Discussions, is a very broad term.

You might have discussed with me or anybody — any discussion.

A. Certainly we have discussed it among ourselves.

Q. What do you mean by that?

[fol. 54] A. The eye, ear, nose and throat practitioners.

Q. When was that discussed?

A. We had a meeting some time back.

Q. Is that a branch of the American Medical Association?

A. We are members of the Medical Association. That was not any branch of it. That was the individuals meeting together.

Q. Was it the organization?

A. Just as a group.

Q. Just oculists or eye doctors who got together informally and discussed it?

A. That is right.

Q. Have you ever heard it discussed in an American Medical Association meeting?

A. No, sir, I have not.

Q. Have you ever heard it discussed at State Medical Association meetings?

A. I heard it discussed at the State Eye, Ear, Nose and

Throat meeting.

Q. Have you ever heard it discussed in your local meet-

ings of the American Medical Association?

(Tr. p. 201) A. I have never heard it discussed. It was brought up once and one individual talked about it for a few minutes.

Redirect examination of Dr. Paul Black.

By Mr. Thigpen:

Q. What professional societies are you a member of, Dr. Black?

A. The Eye, Ear, Nose and Throat Society of North Carolina.

[fol. 55] Q. Are you a member of the American Medical Society.

A. Yes, sir, and State and county Medical societies.

Q. Has any action ever been taken by any medical society condemning the receipt of trade discounts that you have received?

A. Not that I know of.

The Court: Doctor, of those patients of yours to whom you give prescriptions under the contract you mentioned, are there any of them who take their prescriptions to other than the petitioners in this case?

The Witness: Yes, sir.

The Court: In those instances is there any re— any difference in the treatment to you, that you accord such patients or the contracts that you make with them?

The Witness: No, sir.

(Tr. p. 202) The Court: When you examine a patient's eyes and give him a prescription you charge him a fee. Is that true?

The Witness: Yes.

The Court: And the patient pays you? The Witness: Yes, some of them do.

The Court: I wish all of them did. Then you give him a prescription and they take that to a particular place to have filled. Is that true?

The Witness: To some I recommend it.

The Court: When you make that recommendation or when they do take it, do you tell them, or do they know that [fol. 56] they are paying one-third of the amount they pay that company in fact to you?

The Witness: Some do: most of them don't.

Recross-examination of Dr. Paul Black.

By Mr. Maddox:

Q. The doctors that are here with you—are they members of this same Association?

A. Yes, sir.

Q. Have they discussed this general proposition among themselves?

A. All I can speak about is for those in Wilmington. We have discussed it.

Q. The Wilmington group? (Tr. p. 203) A. Yes, sir.

Direct examination of Dr. David B. Sloan.

By Mr. Thigpen:

Q. What is your address, Doctor?
A. Wilmington, North Carolina.

Q. How old are you?

A. I was born September 18, 1889.

Q. That makes you about what?

A. Fifty-nine.

Q. What profession are you engaged in?

A. I am doing eye, ear, nose and throat work in Wilmington, North Carolina.

Q. Tell His Honor briefly your education and medical-

A. I graduated from the Academic Department, Univer-[fol. 57] sity of (Tr. p. 204) North Carolina, and then the University of Pennsylvania Medical School.

Q. When.

A. 1914. I graduated in 1910 from the University of North Carolina.

Q. When were you admitted to the practice of medicine?

A. 1914, sir.

Q. Was that the general practice of medicine?

. A. Yes.

Q. When did you start specializing?

A. I went to work in Wilmington doing the work I am doing now on March 9, 1920.

Q. What is that work that you now do?

A. I am doing eye. ear, nose and throat work.

Q. Do [So] you have been an eye doctor since about 1922, did you say?

A, 1920, sir.

Q. 1920?

A. Yes, sir.

Q. What professional societies are you a member of?

A. I am a member of the County Medical Society, the State Medical Society, the North Carolina Eye, Ear, Nose and Throat Society, the Southern Medical Society and American Medical Association.

Q. How long have you known Mr. Thomas B. Lilly?

(Tr. p. 205) A. I cannot answer that question definitely but approximately 25 years I would say.

Q. What business is he engaged in?

A. He is a manufacturing optician.

Q. What is the name of that business?

A. City Optical Company.

Q. Dr. Sloan, in this proceeding we have a question with [fol. 58] regard to what is termed "trade discounts al-

lowed." Explain to His Honor, if you will, what you know of the trade discounts allowed by the City Optical Company.

A. The trade discounts allowed by City Optical Company to us amounts to 331/3 per cent of the profit [price] he takes in over there on our prescriptions.

Q. Of the amount the City Optical Company takes in on

a prescription that you write?

A. Yes, sir.

Q. What is that arrangement? Why is that made?

A. We feel like it is done for the professional services

rendered the patient.

Q. I wear glasses, Dr. Sloan. Suppose I came to you as a patient and you wrote a prescription for my glasses. Will you outline briefly what I might do with prescription and then what I pay for my glasses; and what you get back or what you get from that amount?

A. I give you the prescription which you take to get (Tr. p. 206) filled wherever you choose to get it filled, and when filled by Mr. Lilly or any outside concern a third of the profit that comes from that prescription is refunded

to me.

Q. Is any memorandum from the sales to your patients submitted to you from time to time?

A. A monthly statement is rendered.

Q. Dr. Sloan, what does that list that is submitted to you each month show?

Mr. Maddox: I suggest, Your Honor, the list would be the best evidence of what the list shows.

Mr. Thigpen: The only purpose, may it please Your Honor, is to clarify a little mix-up in his testimony as to profit as against the amount paid. I submit we could have [fol. 59] brought in a lot of lists and could have been here a week proving every transaction, but I am merely trying to bring out from this witness the custom of the trade and this arrangement.

The Court: If it is directed to the custom of the trade we

will overrule the objection and note an exception.

By Mr. Thigpen:

Q. Answer the question, Doctor.

A. The list submitted each month is the list of the patients

chronologically as we see them, and as they go to City Optical Company, with the patient's name and the amount paid for the glasses, and

(Tr. p. 207) Q. Stop right there.

The Court: I would like you to finish. You said "and." Did you mean "and stating the 1/3 that was payable" to you?

The Witness: Yes, sir.

By Mr. Thigpen:

Q. Dr. Sloan, is this trade discount allowance generally a custom of the profession?

A. To my knowledge, yes, sir.

Q. Did you receive such trade discounts from other manufacturing optical companies.

A. Yes, sir.

Q. When you received these trade allowances how did you consider them and how did you treat them?

A. As money received for services rendered, deposited [fol. 60] in the bank and accounted for with all reports made to the Government.

Q. Did you include it in your income as professional receipts?

A. I think so. I am not sure about that particular point.

Q. What has been your experience with the City Optical Company over the years as to the quality of their work and service to patients?

A. It has been excellent.

Q. Dr. Sloan, do you know of any public policy or law, (Tr. p. 208) Federal or state, that the receipt by you of these trade discounts would violate or does violate?

A. I do not, sir.

Q. Do you know of any professional code of ethics or any provision of the ethics of the medical association that the receipt of these trade discounts would violate or does yieldte?

A. I do not, sir.

By Mr. Maddox:

Q. Now, Dr. Sloan, will you briefly state why you consider the third of the amount charged your patients by the City Optical Company for glasses they have made up on your prescriptions, are trade discounts? What do you mean by that?

A. Sir

Q. What do you mean denominating that third that you get from City Optical Company, which they collect from your patients for the glasses they make for your patients—why do you consider that a trade discount? [fol. 61] A. We consider that due us because of services rendered to the patient. He comes back and gets his glasses checked and rechecked.

We request all of them to do that. If for any reason we made an error in the prescription we correct that, as we do (Tr. p. 209) frequently, for which we make no charge, and Mr. Lilly gives them for which he makes no charge.

Q. When you first examine the patient do you charge him a professional fee?

A. Yes. sir.

Q. Do I understand then that the third that you get from City Optical Company, that is an amount representing one-third of that which the City Optical Company charges your patient for the finished glasses—do I understand that is insurance against your mistakes? Is that as I understand?

A. No, it is not. It is given to us for the welfare of the

patient.

We request them to come back and if anything is wrong we adjust the glasses and correct them and we think the amount of money is due us for this particular service rendered to the patient.

Q. The third due you for what you do after the patient gets the glasses. Is that correct?

A. For the whole procedure.

Q. Suppose the patient doesn't come back?

A. Well, we request him to and we are there to serve him if he does come back.

Q. Now, your examination of the patient when he first comes to you is quite an extended examination, isn't it?

A. Sometimes it is, sir.

[fol. 62] (Tr. p. 210) Q. Isn't it always?

A. As a rule it is, yes, sign

Q. Does it consume a considerable time?

A. Yes, sir.

Q. Requiring quite a few examinations from different points of view?

A. Yes, sir, that is right.

Q. Now, this reexamination that you talked about when the patient comes back with the finished glasses, what does that amount to?

A. The patient is brought in and checked.

Q. How is he checked!

A. I neutralize the glasses with the prescription given him.

Q. You take the glasses given the patient and compare

them with the test fenses you have?

A. With the lenses I have and the prescription as written, and then I see what he sees with the glasses, if his vision is satisfactory. If not we try to find out why it is not.

Q. And that consumes not a great deal of time, does it?

A. No.

Q. Now, have you read anything with reference to the practice of optical companies paying doctors a third or a percentage of the price charged patients for finished glasses?

(Tr. p. 211) A. I have, sir.

Q. Have you heard discussion on the subject?

A: Yes, sir.

Q. Have you heard it discussed in your medical meetings?

A. Personally I have not, sir.

[fol. 63] Q. Do you attend those meetings?

A. As a rule, sir. I was not attending the one last year, however.

Q. Have you heard what was discussed?

A. I have, sir.

Q. Have you read it in any medical journals?

A. Yes, sir.

Q. I beg your pardon?

A. I have read articles—not what was discussed at our particular meeting but I have read discussions on the subject in the medical journal.

Q. In the medical journals?

A. Yes, sir.

Direct examination of Dr. George C. Allen.

By Mr. Thigpen:

(Tr. p. 213) Q. Where do you live?

A. In Lumberton.

Q. Lumberton, North Carolina.

A. Lumberton, North Carolina, yes.

Q. What is your age?

A. 42.

Q. What profession are you engaged in?

A. Physician, eye, ear, nose and throat.

Q. Outline briefly for His Honor your medical training

and experience.

A. My academic work was at the University of North Carolina, A. B. degree in 1928, 2 years of medicine at the University of North Carolina, M. D. degree from the University of Chicago, in 1932.

[fol. 64] (Tr. p. 214) Q. When were you admitted to the

practice of medicine?

A. 1933.

Q. Was that the general practice of medicine?

A. Yes, sir.

Q. When did you specialize or limit your practice?

A. 1941.

Q. What specialty did you engage in?

A. Eye, ear, nose and throat.

Q. What professional deties are you a member of?

A. I am a member of Robeson County Medical Society, the North Carolina State Medical Society, American Medical Association, North Carolina Eye, Ear, Nose and Throat Society and the Pan-American Society of Ophthalmology.

Q. How long have you known Thomas B. Lilly.

A. Since 1941.

Q. Tell us briefly about your first contact with Mr. Lilly.

A. My first contact with Mr. Lilly was at Wilmington at the City Optical Company, making arrangements to obtain my optical supplies from him.

Q. And that was about the time you started the specialty

of being an eye doctor at Lumberton?

A. That was at the time I began that.

Q. How long have you known Helen W. Lilly?

A. I have known her since the same time, the last of (Tr. p. 215) 1941.

Q. What business are Mr. Lilly and Mrs. Lilly en-

gaged in?

A. The optical business, opticians.

Q. Do you know the name of the firm?

A. Yes, sir.

[fol. 65] Q. What is it?

A. City Optical Company.

Q. Dr. Allen, one of the questions involved in this case has to do with what has been termed trade discounts allowed to doctors by the City Optical Company. Tell His Honor what you know about trade discounts and how they were worked out.

A. Trade discounts were paid to ophthalmologists much longer than I knew anything about it because I came in later but—

Q. Just limit it to what you know from your own experience.

A. I have received trade discounts from City Optical Company. Is that what you want?

Q. What do those trade discounts represent?

A. You mean in amount?

Q. That they pay to you. What do they represent?

A. They represent 1/3rd of the retail price of the glasses.

(Tr. p. 216) Q. Dr. Allen, suppose I came to you as a patient and you examined my eyes. Just outline to the Court briefly what you would do with respect to prescribing and suggesting that I have my glasses made.

A. When I examine a patient's eyes for glasses I determine the prescription I am going to give him and write the

prescription and give it to him.

Q. Then what does the patient do with the prescription?

A. The patient takes it to some optical company.

Q. And the optical company does what with that prescription?

[fel. 66] A. They grind their lenses and mount them in frames and deliver those glasses to the patient. . .

Q. Who pays the optical company?

A. The patient.

. Q. Then does the City Optical Company or any optical company that fills a prescription for a patient, give you a memorandum of those transactions?

A. Yes, sir.

Q. And do they remit to you any portion of what the patient, paid?

A. Yes, sir.

Q. What portion?

A. 33 and 1/3 percent.

Q. What do you know about this practice? Is it a (Tr. p. 217) general custom?

A. So far as I have been able to find out it is.

Q. How did you consider these trade discounts that you received?

A. I considered that as a part of our fee to help take care of replacements, adjustments, re-examinations and so forth.

Q. What did you do with these trade discounts that you received? Did you report them in your income tax return?

A. Yes, sir. Q. Do you know any public policy or any Federal or state. law that the receipt by you of such trade discounts violated?

A. No. sir.

Q. Do you know of any canon of othics of the Medical Society that the receipt of such trade discounts violates?

A. No, sir, not officially:

[fol. 67] Q. Do you know unofficially of any canon of ethics that is violated?

A. There have been some rumors and a meeting of the North Carolina Eye, Ear, Nose and Throat Society, I. believe, last year, while not making it-

Q. Did you attend that meeting?

A. No, sir.

Cross-examination of Dr. George C. Allen.

By Mr. Maddox:

(Tr. p. 219) Q. Doctor, what was your first contact with Thomas B. Lilly in 1941?

A. It was arranging to obtain my optical supplies from him.

Q. Did you seek him?

A. Yes, sir.

Q: What optical supplies did fou need?

· A. I was dispensing glasses at the time. I needed all of my lenses, frames, some equipment for examining patients.

Q. What was the first occasion for meeting Helen W.

Lilly in 1941?

A. That occasion was that she happened to be in the City Optical Company in Wilmington when I was in there.

(Tr. p. 220). Q. Now, your understanding of trade discounts allowed is that you are to receive 1/3rd of the retail price of glasses collected by the City Optical Company [fol. 68] from your patients that go to the City Optical Company. Is that your understanding of that term?

A. That was a verbal understanding, yes, sir.

Q. Now, when you examine the patient's eyes do you charge him a fee?

A. Yes, sir.

Q. And do you tell him to go to City Optical Company?

A. In our town that is the only place they have. If (Tr. p. 221) they should desire—many of them ask if they can go to another place, another town, and the prescription is theirs and they can take it any place they choose.

· Q. You mean the Lumberton branch?

A. The Lumberton branche yes, sir. If they are filled there they have to go there.

Q. Do you go to that branch often?

A. Yes, sir.

Q. How often?

A. I suppose I am in there probably 3 or 4 times a week.

Q. Are those social calls or business calls?

A. Usually business.

Q. What is that, getting glasses?

A. Usually it is to take a pair to [of] glasses somebody has mailed in to me down for replacing lenses or repairing some broken part or, occasionally some adjustment that needs to be made.

Q. Isn't it necessary for the person to go there for those

adjustments?

A. Out-of-town patients many times mail their glasses in and want them mailed back out to them after they are repaired.

[fold 69] Q. Now, you say that the payment of 1/3rd of the retail price of the glasses paid by the patient is the general cus- (Tr. p. 222) tom. Just what do you mean by that?

A. By that I mean that it has been done much longer

than my experience in the practice of ophthalmology.

Q. Does it mean that all optical companies pay ophthalmologists 1/3rd of the retail price of glasses furnished patients?

A. No, sir.

Q. Then what does it mean in that sense?

A. Our arrangement is probably more for convenience. The optical company is acting as our agent, whereas we could dispense the glasses ourselves and charge a retail price for the glasses and receive our glasses from the optical company on a wholesale basis.

That is done to save us the trouble of measuring frames,

adjusting frames and fitting them on the patient.

It is considered that we receive that trade discount rather than dispense the glasses ourselves and pay the optical company the wholesale fee.

Q. Where did you get the understanding that the optical

company was your agent?

A. That has been my general impression about the way that was handled since it first began being done, and in my case it was in 1946.

Before that time I had a wholesale account, all my glasses were made by the City Optical Company in Wilmington (Tr. p. 223) and I adjusted and fitted them on the patient and made the usual retail charge for the glasses.

Q. Was this agency viewpoint the matter that was discussed in the medical meeting or among the eye, ear, nose

and throat doctors?

[fol. 70] A. I was not-

Mr. Thigpen: I object to that, Your Henor. He stated that he was not at the medical meeting.

By Mr. Maddox

Q. Has it been discussed informally among eye, ear, nose and throat doctors?

A. Yes, sir. .

Q. The nature of the relationship between the doctor and the optical company?

A. Yes, sir, it has been discussed informally many times

in that light.

Q. I believe you said that shen you made the examination you charged the patient a fee.

A. That is right.

Q. Do you tell the prtient when you give him a prescription that you expect to get a third of what he pays for the finished glasses?

A. No, sir. If they ask me I will tell them.

Q. Do they ever ask?

A. I don't know of but 2 or 3 instances where they (Tr. p. 224) ever have.

Q. In your experience?

A. Yes, Sir.

Q. And when they asked did you tell them?

A. Yes, sir.

Q. What was their reply or did they make a reply?

A. I don't believe they had any reply to it.

Q. No reply? What was their attitude then?

A. I don't recall shyone making any remark about it.

Q. Did they ask any further questions?

A. No, sir.

[fol. 71] Q. You don't recall of any. Now, you say the 1/3rd of the price the patient pays the optical company for the finished glasses is to help take care of replacements, adjustments and re-examinations.

b that what I understand you to say?

A. Yes, sir.

Q. What do you mean by "replacements"?

A. In case you have—and you have a certain number—a case where the lenses will not be tolerated by a patient or

they may have been incorrectly ground or they may be incorrectly fitted. In those cases the patients are reexamined, new lenses, if necessary, are furnished at no charge to a patient; a patient might lie down and go to sleep with his glasses on and get them bent and have to come in to get the (Tr. p. 225) frames straightened and adjusted to the face, and things of that kind, over a period of maybe 2 years after the original examination, and that is done at no charge to the patient.

Q. Do you give him an entire re-examination at his eyes,

after 2 years?

A. Not an entire re-examination of the eyes. Any adjust-

Q. Of the frames?

A. Of the frames, yes, sir.

Q. Now, comparatively few come back, do they?

A. Not very many.. Probably I would say not more than 1 in 20.

(Tr. p. 227) Q. Now, you stated that you got a monthly statement, a monthly memorandum of your patients for whom City Optical Company had made glasses.

A. Yes, sir.

[fol. 72] Q. Do you still receive those memos?

A. No, sir.

Q. When did they stop?

(Tri p. 228) The Witness: February, 1946.

Mr. Thigpen: May it please the Court, I move to strike the answer. It is not pertinent to the taxable year 1943 and 1944. All this witness was brought here for was to testify to a trade custom of these discounts and allowances that were actually handled, paid and accrued in the taxable years under consideration. The fact that they stopped makes no difference.

The Court: We understand that only 2 years are involved here but we are not willing to say that what happened in reference to these memoranda would not be relevant in reference to the question being discussed here. Overruled;

exception.

By Mr. Maddox:

Q. Now, doctor, have you ever read anything on the public policy of the practice of optical companies paying 1 and of the retail price of glasses charged the patients to the examining doctor?

A. No, sir, I don't believe I have read anything.

Q. And never heard any discussions?

A. Oh, yes, I have heard it discussed.

[fol. 73] Direct examination of Dr. Louten R. Hedgpath.

By Mr. Thigpen:

(Tr. p. 229) Q. Where do you live, Dr. Hodgpath?

A. Lumberton.

Q. Lumberton, North Carolina !

A. Yes.

Q. What is your age?

A. 40.

Q. What profession are you engaged in?

A. The practice of eye, ear, nose and throat:

Q. Outline briefly for His Honor your medical training.

A. I finished the University of Maryland, Baltimore, in 1931 and I interned in the University of Maryland, Baltimore Eye, Ear, Nose and Throat Hospital, and Baker Sanitarium, and got my first post-graduate at Baltimore Eye, Ear, (Tr. p. 230) Nose and Throat at Baltimore.

Q. When were you admitted to the practice of medicine?

A. In 1933.

Q. Was that the general practice of medicine?

A. Yes, sir.

Q. When did you limit your practice?

A. 1935.

Q. To what branch of medicine?

A. Eye, ear, nose and throat.

Q. What professional societies are you a member of?

A. I belong to American Medical Society, Robeson County Medical Society, North Carolina State Medical Society, and North Carolina Eye, Ear, Nose and Throat Society, Q. How long have you known Mr. Thomas B. Lilly? [fol. 74] A. Since 1935.

Q. How long have You known Helen W. Lilly?

A. Since 1937. 🐞 🔞

Q. What business are they engaged in?

A. In the optical business.

Q. You know the name of the firm?

A. City Optical Company.

Q. Explain some business contacts that you have had with the Lillys and what you know about their business.

A. When I first started practicing in Lumberton I started to give my business to American Optical Company and

(Tr. p. 231) the Southeastern.

Mr. Lilly called on me and for 2 or 3 years I gave him a small amount of business and I think in 1940—1930 or 1940—I began giving more business to City Optical Company and, around 1941 or 1942 I was doing 100 percent business with the City Optical Company in Wilmington.

(Tr. p. 232) Q. Dr. Hedgpath, one of the important questions in this case has to do with trade discounts allowed doctors by the City Optical Company. Could you tell us briefly your experience with trade discounts and what they are?

A. They call it that. I thought it was service we ren-

dered after we gave out glasses.

When you came into my office and I examine your eyes I advise you to come back for a recheck to see if the pre-coription is properly filled and the lenses fitted. Ordinarily a pair of glasses will last a patient from 2 to 3 years under ordinary conditions. Some patients don't come back and

the majority do for a recheck.

[fol. 75] In the majority of cases during that 2 years time (Tr. p. 233) they lay down and go to sleep and get a misadjustment of their frames and sometimes we make a mistake in the lenses, especially with astigmatism, with the axis, and we have to send them back and have them reground. There is no charge to the patient if they come in 5 or 6 times for adjustments.

Q. Dr. Hedgpath, I wear glasses. Suppose I can to you as a patient and you examined my eyes and you wrote.

out a prescription for new glasses or adjustments. Tell what you would say to me as a patient and what I would do with that prescription, and then what would happen afterwards with regard to the manufacture of those glasses.

A. The prescriptions I have have "City Optical Company" printed on the bottom just like my drug store prescriptions have the name of the drug store. I do not tell you where to get them but I tell you to get these glasses fitted.

We have a lot that go to Fayetteville, to McBride, and other companies also, and some go to Wilmington as they have been getting them from Wilmington.

What was the last of the question?

Q. After I go to the optical company to have my glasses

maus do they-

A: At the end of the month the ones that go to the optical company—talking bout the City Optical Company—after the 10th of the month we get a check and a list of the prescriptions that were filled there and a check for 33 and (Tr. p. 234) a 3rd percent of the amount of money that was taken in on these prescriptions.

Q. That is the retail price of the glasses?

A. Yes, sir.

[fol. 76] Q. Did you ever do any dispensing yourself?

A. Yes, sir.

Q./When you dispensed glasses yourself how did you procure the glasses for your patients?

A. I bought the frames wholesale.

Q. And then when you sold the glasses to the patient

what did you charge the patient?

A. Charged aim the retail prescription prices listed by American Optical and Southeastern and all optical companies.

Q. What was the difference between the profit you made on the dispensing you did yourself and this trade discount for dispensing made by City Optical Company, in your opinion?

A. In my opinion we made a lot more money when dispensing ourselves, but doing a combined practice I did not have time and had someone else do the work for me for the difference in a oney.

Q. Is this a very widespread custom with regard to trade discounts allowed doctors?

A. Yes, sir.

(Tr. p. 235) Q. How did you consider these trade discounts when you received them? How did you treat them on your books and records?

A. They went down in my deposits as money received

from my profession.

Q. Did you include them in your income tax return?

A. Yes, sir.

Q. Dr. Hedgpath, do you know of any Federal or state law or any public policy that the receipt of these trade discounts by you violates?

A. In my opinion, no, sir.

[fol. 77] Q. Do you know of any canon of p of essional ethics that the receipt of these trade discounts violates?

A. No, sir.

Cross-examination of Dr. Louten R. Hedgpath.

By Mr. Maddox:

(Tr. p. 236) Q. Now, you said when you were in Lumberton, I believe, you dealt with the American Optical Company and the Southeastern Optical Company.

A. Yes, sir.

Q. Where were they located?

A. American Optical Company was located in Raleigh and the branch of Southeastern I did business with was in Petersburg, Virginia.

Q. And you contacted them by mail?

A. Yes, sir. They had salesmen that came around too.

Q. Did you mail the prescription you wrote for the patient to them?

A. Yes, sir, with the frames.

Q. You bought the frames and mailed the frame and prescription to the American Optical Company?

A. Yes, sir, and Southeastern.

Q. And they made up the lens and put them in the frame and mailed the tinished product back to you?

A. Yes, sir.

Q. And that continued, I guess, until 1946?

(Trap 237) A. It continued until the City Optical Company opened a branch in Lumberton. Of course. I did business with the Wilmington branch too.

[fol. 78] Q. And between 1941 and 1946 you dealt solely

with City Optical Company?

A. I would say 95 percent of my work was with them, yes, sir.

O. Did you mail the frames to them like you did with the American Optical Company?

A. Yes, sir.

Q. And the prescription?

A. Yes, sir.

Q. And the finished glasses were mailed back to you from Wilmington?

A. Yes, sir.

(Tr. p. 238) Q. Now, the 3rd of the retail price of the glasses paid by the patient which you receive, you say is for services rendered after the glasses are received by the patient. Is that correct?

A. Yes, sir There is no other charge for it if it is needed.

Q. What does that service consist of?

A. It consists of the patient coming in and complaining about not being able to see or having trouble, headaches following examination, and they are rechecked and occasionally you have a difference in an axis which is caused by astigmatism, and you have to have a new precription and have it reground.

Oftentimes, an adjustment on the face, if not setting properly on the nose, will give trouble, and a lot of times you have a nervous woman and you have to do something for

her anyway -or some men are the same way.

Q. That occurs with every patient you have?

A. No, sir.

Q. Nov, how many patients actually come back to you after they get their glasses from City Optical Company?

(Tr. p. 239) A. Let me get that straight.

Q. What proportion or what part of them actually come back after they get their glasses?

A. Well, sir, those that live close to town, you don't have any trouble with. I imagine anywhere from 50 to 60 percent Q. What does a check-up consist of?

A. Seeing that they fit properly and if the right prescription has been put in as prescribed.

Q. Comparing the lenses in the glasses with the test

lenses in your chice?

A. What I prescribed.

Q. And looking at the frames to see that they fit?

A. Yes.

Q. Anything else?

A. As I said before-

Q. Isn't that the usual examination of the patient?

A. State that again.

Q. Isn't that the usual examination the patient gets when they come back?

A. For proper fitting and to see if the glasses are right,

yes, sir.

Q. Now, when you examine the patient's eyes you charge him a fee, do you not?

A. I do, yes, sir.

(Tr. p. 240) Q. And I take it that fee is for the examination and the 3rd of the retail price for the glasses is for the subsequent examination that you are speaking of?

A. That is right, if they need anything further. Any-[fol. 80] thing further with the glasses does not cost a cent

to have it fixed.

Q. Suppose the patient breaks the glasses in his sleep as you testified to on direct examination.

A. If they break them they pay for the lens.

Q. And you get 1/3rd of that, 1/3rd of the price of the lens?

A. I get 1/3rd of that but if they bend the frames it doesn't cost them anything.

Q. Suppose they break the frames?

A. It costs to get them fixed.

Q. A new frame?

A. If you broke the temple you don't need a new frame for that.

Q. I mean part of the frame.

A. You don't need the temples then. You just get the main part, the front of the glass.

Q. Does he pay for that?

A. If he breaks them.

Q. And you get 1/3rd of that?

A. Yes, sir.

(Tr. p. 241) Q. What method do you have to determine what patients of yours go to the City Optical Company?

A. What method?

Q. Yes.

A. I have no method. As I stated, I have my own prescription blanks saying "City Optical Company." They can take the prescription where they want.

Q. Just like a drug store prescription?

A. Yes. Of course, being just one optical company in Lumberton now, 95 percent of them take them to the optical company there.

[fol. 81] Q. Do you get a rebate on the drug store prescrip-

tion like you do on the eye glass prescription?

A. I don't get that. I get a percent off my bill, yes, sir.

Q. And when you give the prescription to the patient or whenever you contact the patient, do you tell him that you will get 1/3rd of the price he pays for the glasses?

A. I have had 3 or 4 to ask me and I have told them.

If they don't ask me I don't tell them.

Q. They don't as a rule ask you?

A. No, sir.

Q. To what do you at-ribute that fact?

A. What fact?

Q. That they don't ask.

or don't know. I don't know whether they don't care or don't know. I don't know that.

Q. But you don't volunteer it?

A. No, sir.

Q. Why don't you volunteeer that information?

A. I didn't think any professional men volunteered where he got his money, whether it is a fee for practicing law or practicing medicine or anything else, sir,

Q. Now, you say the practice is widespread. I take it you mean it is a practice followed by all optical companies and all eye doctors.

A. It is something that was practiced when I started practicing sir, and to my knowledge it is all over the United States.

Q. Practiced by all optical companies, and all eye doctors. Is that correct?

A. As far as I know, sir.

Q. Have you read anything on the public policy question

about this practice?

[fol. 82] A. I have read what was in the paper. That is all I have read about it, sir. The Medical Society of North Carolina has not acted on it as far as I know.

Q. Has it been discussed at meetings?

A. Not to my knowledge. I was not in on any where it has been.

(Tr. p. 243) Q. Has it been discussed out of meetings among the profession?

A. You mean for North Carolina doctors?

Q. Yes.

A. The only thing I know has been discussed is what I read about the doctors in Chicago, about bringing up the civil action.

Q. There is nothing else that you recall?

A. No, sir.

Direct examination of Mrs. Helen W. Lilly.

By Mr. Thigpea:

(Tr. p. 301) Q. Where do you live?

A. Wilmington

Q. How old are you?

A. I was born in 1905, 43 years old.

Q. That would make you how old?

A. 43, pretty near 44.

Q. Tell us briefly your educational training.

A. I was educated in the public schools of Virginia and Farmville State Teachers College; took a B. S. in education at Farmville.

Q. What have you done prior to 1937, prior to your (Tr. p. 302) marriage?

A. In 1924 I started teaching school and taught in the [fol. 83] public schools of Virginia and North Carolina for 6 years, got tired of it and went into Thalhimer's in Richmond as assistant buyer in sportswear and was there 18, months.

I liked teaching school a little better and came to Wilmington in 1933 and I taught, the seventh grade in the

William Hooper School there until 1937.

(Tr. p. 303) Q. When did you marry?

A. October, 1937.

Q. Who did you marry?

A. Thomas B. Lilly.

Q. After your marriage did you accompany your husband on any trips?

A. Yes, sir. I was already interested in eye work and I am very much interested in being with Mr. Lilly, and I be-

gan traveling with him immediately.

Shortly after our marriage we went to Cincinnati to a jobber's convention. There I met the factory representa-(Tr. p. 304) tives and got to know them and saw their exhibits and got interested in the wholesale end of the business.

That was the first time I had become interested in that side of it. I had been a customer and seen it from that

angle for some time.

(Tr. p. 305) Q. Did you have occasion to go to Richmond any time shortly after your marriage or about that time?

A. Just before I was married I was in Richmond almost [fol. 84] continuously because I was getting a trousseau, seeing friends there. My home is not far from there. Since then I have been to Richmond consistently.

Q. Do you know when the Richmond branch of the City

Optical Company was opened?

A. Yes, sir, 1938—the fall of 1937, I mean.

Q. Did you ever discuss the opening of that branch with Mr. Lilly?

.A. Naturally. I was quite interested in a branch being in my home locale.

(Tr. p. 319) Q. Mrs. Lilly, I show you an individual income tax return for 1943 and ask who signed that return.

A. I did.

Q. Your signature is on there?

A. Yes, sir, right here (indicating). (Tr. p. 320) Q. That is your 1943 income tax return?

A. That is right.

Q. I show you the schedule attached to that return and ask you to read the heading on it and the first two items with figures opposite them.

A. "Helen W. Lilly trading as Duke Optical Company, Wilmington, North Carolina, December 31, 1943. Statement of income and profit for year. Merchandise sales \$32.166.04."

Q. The next item.

A. Les discounts and allowances \$6,568.87.

Mr. Thigpen: Petitioner offers in evidence the taxpayer's individual income tax return for the year 1943.

Mr. Maddox: No objection.

The Court: Received with the right to substitute 7fol. 85] a photostatic copy.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 30.)

By Mr. Thigpen:

Q. Mrs. Lilly, I show you the 1944 income tax return and ask you if that is your signature on it.

A. Yes, sir.

Q. And that is your income tax return for 1944?

A. That is right.

Q. I show you a schedule attached to that return and ask, you just to read the heading of it and then the first two (Tr. p. 321) items under "sales."

A. "Duke Optical Company, Fayetteville, North Carolina, profit and loss statement year ended December 31, Merchandise sales \$28,489.07, less trade discounts and allowances \$4,98.35."

0, 0

Mr. Thigpen: Petitioner offers in evidence that individual income tax return for the year 1944.

Mr. Maddox: No objection.

The Court: Received with the right to substitute a photostatic copy.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 31.)

(Tr. p. 325) Q. Mrs. Lilly, one of the principal issues in this case has to do with trade discounts allowed. Will you please tell His Honor what you know about trade discounts allowed?

[fol. 86] A. When I started traveling for the company, and in the interest of the company, I soon learned that trade discounts were allowed doctors for whom we dispensed. I learned they were allowed by other companies to doctors that they dispensed for, because when we wanted to open a new shop in a town that another company was dispensing in, and who were giving trade discounts, we had to sell them on the idea that our work was better.

We consider that those patients belong to the doc-Tr. p. 326) tors, that they go to the doctors for their eye care and that that doctor is going to look after, and he does look after, his patients, not for the few minutes the patient is in the office being examined, but throughout the life of the glasses and, in towns where we do not dispense glasses, where they fit them themselves and do the mechanical work, the patient has to go back to the doctor for fittings and adjustments and refracting at times.

When we went into a town to try to get the doctors to agree to let us do their dispensing for them, they immediately said "No, we don't want to give up the profit we make on the sale of glasses," and I believe in most business the person who distributes gets a profit for so doing, and, we would offer our services to fill the prescriptions, grind the lenses, fit them to the frames and adjust them, and pay them 'ard of the retail price of the pair of the glasses paid by the patient and, give to the doctor a list of the patients and what they paid at the end of each month.

By Mr. Thigpen:

(Tr. p. 367) Q. Mr. Duke, where do you live?

A. Fayetteville, North Carolina.

Q. How old are you?

A. 34.

Q. How long have you lived in Fayetteville?

A. Approximately 15 years.

Q. What business are you engaged in?

A. Optical business.

Q. How long have you been in the optical business?
A. Approximately 18 years.

(Tr. p. 371) Q. Mr. Duke, I hand you this book and ask you to look at the first few pages of it and tell us what that is.

A. This is daily summary beginning—

Q. Daily summary of what?

Q. Daily summary of the business. You mean by that the sales?

A. Of the Duke Optical Company.

(Tr. p. 372) Q. What do you record in that book, Mr.

A. I beg your pardon

Q. What is recorded in that book?

A. Daily sales.

Q. The daily sales. Do you know anything about trade discounts allowed doctors?

A. Yes, sir.

Q. Will you tell His Honor, please, how those trade [fol. 88] discounts were computed and recorded upon the books of the Duke Optical Company, the daily sale summary which you have before you?

A. The patient's name was entered and the amount of money they paid the Duke Optical Company, under the heading of the doctors.

Q. Then at the end of the month what happened?

A. At the end of the month we gave 1/3 back to the doctor.

Q. You computed the total amount in the column under the doctor's name and divided by 3 and remitted to him 1/3rd of the amount collected from the patient?

A. That is right.

Q. Who was ostensibly his patient?

A. That is right.

The Court: Will that book be inquired about any further during the trial? If so let it be marked for identi- (Tr. p. 373) fication as the book from which this witness just testified.

Mr. Thigpen: No, sir, it will not be. I propose, if Your Honor please to offer and tie up the treatment of these discounts in due course. I merely want this manager to demonstrate his knowledge of the practice and how it was actually done.

. By Mr. Thigpen:

Q. Mr. Duke, if a patient came into the Duke Optical Company to buy a pair of glasses without a doctor's prescription, would be pay any more or any less than a patient who comes in with a prescription from a doctor for a pair of glasses?

[fol. 89] A. We cannot sell him a pair of glasses without a

prescription.

Q. Maybe I am a little awkward in my wording. Suppose I came in and wanted a set of frames and I had not been in to see you before and was not a patient of any doctor. What price would you charge me for those frames?

A. That would depend on the type of frame you selected.

Q. Would you charge me the same price you would if I selected the same frames under a doctor's prescription?

A. Yes, sir, the same price.

Cross-examination of L. Thomas Duke.

By Mr. Maddox:

(Tr. p. 375) Mr. Maddox: May I see the book you showed the witness, Mr. Thigpen?

(Tr. p. 376) Q. Now, will you turn to the page you were referring to when you testified on direct examination with reference to the trade discounts allowed?

· A. I was referring to January 3rd.

Q. This record before you?

A. This one.
Q. Which one, on the right or left?

A. They are the same.

Q. Now, Mr. Witness, do you have an account in this book designated "Trade Discounts Allowed"?

A. Yes, there are 5.

[fol. 90] Q. Will you show me those?

A. The first 5 (indicating).

Q. Where do those words appear, "Trade Discounts Allowed"?

A. The heading in the first column.

Q. What is that word there (indicating)?

A. "Kesler".

Q. And that means what?

A. That was the doctor's name, his last name.

Q. But there is no account in the book which has as a heading "Trade Discounts Allowed"?

A. That is the way we always wrote the doctor's name in.

(Tr. p. 377) Q. And the doctor's name at the head of the column is what you refer to as "Trade discount Allowed"!

A. That is correct, sir.

Q. Now, I wish you would run through that book casually and tell me if there are any other accounts in any other columns with any other doctor's name, other than the name of Dr. Kesler heading it.

A. January 4, Dr. O. L. McFaydgen.

Q. Examine the complete book. I don't want you to turn it leaf by leaf.

A. Is there any particular date you would like to have?

Q./Just observe it.

A. Dr. McCov.

Q. In going through that book, Dr. Kesler is the principal doctor to whom you paid the socalled trade discounts allowed, isn't he, in 1942, and 1943?

Mr. Thigpen: If Your Honor please, the book relates only to 1944, I think, not to 1942 and 1943.

[fol. 91] •Mr. Maddox: It looks like there was apparently an error in the first page. It is headed 1943. The first page is dated 1943 by mistake perhaps.

By Mr. Mattox:

Q. Was he the doctor from whom most of the business came in Fayetteville, Dr. Kesler?

(Tr. p. 378) A. Yes, sir.

Q. In 1944?

A. Yes, sir.

Q. Was there any other optician in Fayetteville?

A. Two.

Q. Who were they !-

A. City Optical Company and McBride Optician.

Q. Did you have complete machinery in Fayetteville?

A. Yes.

Q. Now, you mentioned the price of frames, what you would charge a person who came in without a prescription. How do you determine that price?

A. How do we determine the price?

(Tr. p. 379) Q. Yes, how do you determine the price of the frames.

A. The quality of the frame determines the price.

Q. Depending on the quality of the frame how do you determine the price?

A. Depending on the quality of the frame.

Q. Where do you get the price, from a catalogue?

A. No, we don't have any catalogues.

Q. How do you determine the price?

A. That is based on wholesale prices throughout the business. I guess they figure that on a margin of profit.

[fol. 92] Q. You fixed the price yourself?

A. Yes, sir.

Q. And you could have sold the person without a prescription for a less amount than you indicated in your direct examination?

A. I don't know. We have to figure our overhead somewhere.

Q. Well, in filling a prescription you know a 3rd is going to the doctor, do you not?

A. That is correct.

Q. And in not filling the prescription you have at least a 3rd leeway. Is that right?

A. That is right.

Q. If you were to reduce the price of the frame \(^1\)3rd to the customer without a prescription—

(Tr. p. 380) A. You could.

Q. Did you do that?

A. No.

Direct examination of EMILE C. BRYAN.

By Mr. Thigpen:

Q. Mr. Bryan, where do you live?

A. Richmond, Virginia,

Q. How old are you?

A. 35.

'Q. What business are you in?

A. The optical business.

Q. How long bave you been in that business?

A. Since 1931. .

Q. What is your present connection?

[fol. 93] (Tr. p. 381) A. I am manager of the office.

Q. What office?

A. Richmond Optical Company.

Q. Who owns the Richmond Optical Company?

A. Mr. and Mrs. Thomas B. Lilly.

Q. How long did you say you had been in the optical business?

A. Since 1931.

Q. Briefly tell His Honer where you have worked in the optical business.

A. I worked in the optical business starting in New Orleans, and from there I went to Nashville, Tennessee, then to Jackson, Tennessee, to Memphis, Tennessee, and then to Wilmington, North Carolina.

Q. For whom did you work in Wilmington, North Carolina?

A. Mr. Thomas B. Lilly.

Q. When was that connection?

A. In 1940

Q. When and you go to Richmond!

A. I went to Richmond in 1941.

(Tr. p. 382) Q. In your wide experience in the optical business did you ever come in contact with what we call trade discounts' allowed?

A. Yes, sir.

Q. Explain to His Honor what trade discounts allowed

really means in your experience.

A. A trade discount is a refund made to the doctor on the gross sales resulting from prescriptions or business directed to us by him.

Q. Mr. Bryan, I show you these leaves of ledger sheets [fol. 94] or papers, whatever we want to designate them,

and ask if you can identify that group of papers.

'A. This is a portion of the summary book, a record of each day's business for the month of January, 1942.

Q. The month of January, 1942?

A. Yes, sir, 1942.

Q. Take any page you have open there. Will you explain to His Honor how, in the Richmond branch, you kept track of the sales you made upon doctor's prescriptions and determined the trade discounts allowed and paid to those doctors in January, 1942, and which I take it is the same (Tr. p. 383) practice in 1943 and 1944.

A. We kept a column on the extreme left-hand side, a detailed column of each amount of cash collected for each particular doctor. Each doctor has his heading on the column and at the end of the month it is totaled up for each doctor and he receives a portion of that total amount.

Q. Roughly, what is that portion of that total amount?

A. It is 33 and a 3rd percent.

Q. 33 and a 3rd percent?

A. 33 and a 3rd percent.

Crossexamination of Emile C. Bryan.

By Mr. Maddox:

(Tr. p. 385) Q. Now, as manager, aside from suggestions from Mr. (Tr. p. 386) Lilly, how do you run the Richmond Optical Company in Richmond! Just what are your duties! [fol. 95] A. I wait on the public, take the prescriptions in, deliver the prescriptions.

Q. Do you supervise the mechanical end of it?

A. I supervise the mechanical end of it.

Q. Do you call on doctors?

A. Yes, sir.

Q. Do you call on other optical companies?

A. No. sir.

Q. You don't do business with any other optical com-

A. No, sir.

Q. Your business is strictly with patients-

A. Yes, sir.

Q. Of oculists!

A. Yes, sir..

Q. How often do you visit the doctors?

A. I don't visit them at any particular time. I don't have any definite time to visit them. I see all of them occasionally.

. Q. Did your duties as manager include the drawing of the checks for the 33 and a 3rd percent that went to the

doctors?

A. No, sir.

(Tr. p. 587) Q. Who did that?

A. That was done in Wilmington.

Q. Done in Wilmington?

A. Yes.

Q. You accumulated the total in the column in the book that you referred to?

. A. Yes, sir.

Q. Did you keep that book, you yourself?

A. Are you referring to the summary book?

[fol. 96] O. The book that you referred to in your direct examination.

A. Yes, sir.

Q. And from that book you extracted the figures and mailed them to Wilmington. Is that it?

A. That is correct.

Q. Now, referring to the paper that you referred to in your direct examination—did you refer to it as the sales journal?

A. I believed I referred to it as the summary book, a

record of each day's transactions.

Q. And on the first page, January 2, 1942, in a column headed "Thos" what does that indicate?

A. Dr. Thomason.

Q. And the next one is "Shep"-what does that refer to?

A. Da Shepherd.

(Tr. p. 388) Q. And the next one is "Perkins".

A. That is correct.

Q. Now does each sheet represent a month?

A. Each sheet represents a day each double sheet.

Q. Now, take the item "J. R. Cole" and under "Perkins" you have \$10 listed. What was the amount charged the patient in that instance?

A. The amount charged the patient was \$10.

Q. And you remitted \$10 to the doctor?

A. No. sir.

Q. The \$10 means the amount of the patient's charge?

A. \$10 was the amount collected from the patient.

Q. And at the end of the month under "Dr. Perkins" you would have the total amount charged?

[fol. 97] Do you have before you the total figure for Dr. Perkins for that month?

· A. No, sir. I could get it by adding these columns up.

(Tr. p. 389) Q. At the end of the month then you go through each page and total each column and arrive at the that amount in that manner?

A. That is correct.

Q. And you mail that information to Wilmington. Is

A. That is correct.

Q. You don't take 1/3rd of it!

A. Well, we divide it by 3 and put the 33 and the 3rd sper cent down, or we send it in as a total and they do that.

Q. I am trying to find out what you send to Wilmington. Do you send the total of that amount charged——

A. An itemized list of-

Q. Wait a minute. Do you send a total of the amounts charged Dr. Perkins' patients!

A. That is correct.

Q. Or do you send 1/3rd of that amount?

A. We send the total of the amounts charged to his patients.

Q. But no where in this record is shown the total for the month?

A. No, sir.

Q. Now, in this record which you say is typical of the record kept in this respect, is there any account headed. "Trade Discounts Allowed"?

(Tr. p. 390) A. No, sir.

Q. Where did you get that designation?

A. What designation?

Q. Trade Discounts allowed.

[fol. 98] A. It has always been customary to call it that.

Q. Did you ever hear it called anything else?

A. I have heard it referred to as commissions, doctors' commissions or rebates.

Q. Anything else!

A. I recently heard it referred to as a kick-back.

Redirect examination of Emile C. Bryan,

By Mr. Thigpen:

(Xr. p. 391) Q. Mr. Bryan, those sheets you have there are a mere summary of the sales. Is that correct?

A. That is correct.

Q. And those sheets do not purport to accrue any trade discounts allowed to doctors, do they?

A. No, sir.

Q. This is just a record of sales made on doctors' prescriptions and the amounts collected?

A. That is correct.

Q. Mr. Bryan, if a patient came to you in Richmond and a purchased a pair of frames without a doctor's prescription, would that price be the same that a patient would pay if

he came in and bought a pair of frames with a doctor's precrip (Tr. p. 392) tion?

A. Yes, sir.

Recross-examination of Emile C. Bryan.

By Mr. Maddox:

Q. Just a question or two. Did you keep a record in [fol. 99] Richmond of amounts accrued to doctors other than the record that you have in your hand?

A. No, sir.

Q. The record you have in your hand, does that consist of the sole record kept in Richmond?

A. Yes, sir.

Q. No other record?

A. No, sir.

Q. And from this record you transmitted the information to Wilmington?

A. That is correct.

Q. With reference to the last question Mr. Thigpen asked you about the frames, how do you ascertain the price you are going to charge the customer for the frame?

A. We have an established price!

Q. And in what form is that established price? Where do you look for that?

A. It is in line with other optical companies' prices.

Q. Well, if you wanted the price on a certain frame (Tr. p. 393) where would you go to find it?

A. We would know the prices of the frames?

Q. How do you first know then when a new frame comes in that you have never before seen; how do you ascertain the price!

A. We know what to sell it for by our costs and from knowing what it sells for in other places in Richmond,

Q. Do you go around to the various stores to find out what they are selling for in order to find out what to charge for the frame!

A. I have on occasion.

Q. Is there such a thing as a price list?

A. I have not had a printed retail price list.

[fol. 100] Q. Have you had one unprinted, a typed price list?

A. No, sir.

Q. Have you had any price list other than printed?

A. No, sir.

Q. Do you ever inquire of Mr. Lilly as to the price of a frame, for instance?

A. Yes, sir.

Q. Where do you- frames come from that you sell in Richmond?

A. From City Optical Company in Wilmington.

Direct examination of WILLIAM H. LIGHTFOOT.

By Mr. Thigpen:

(Tr. p. 394) Q. Mr. Lightfoot, where do you live?

A. In Greensboro, 115 South Tremont Drive.

Q. How old are you, Mr. Lightfoot?

A. 40.

Q. What business are you engaged in ?

A. The optical business.

Q. How long have you been in that business?

A. Nearly 24 years.

Q. How - have you been in Greensboro!

A. 18-I am in my 19th year now.

Q. For what optical companies have you worked?

A. Well, originally in Newport News, Virginia for the White Optical Company where I learned the business. I came to Greensboro with American Optical Company and was with them (Tr. p. 395) nearly 10 years, and I came with the City Optical Company in the year 1939.

[fol. 101] Q. Mr. Lightfoot, I show you these sheets and ask you to tell His Honor please, what this represents, what

these pages are supposed to record.

A. These are pages from our summary book that is kept (Tr. p. 396) daily.

Q. Summary book of what?

A. City Optical Company of Greensboro.

Q. What do they reflect?

A. They reflect the amounts collected for each doctor and credited to their accounts.

Q. How would you collect an amount for a doctor?

A. I would collect the retail price.

Q. From whom?

A. From the patient.

Q. So if a patient brought a prescription in and paid the retail price you would enter the amount collected from the patient on those summaries, would you?

A. That is right, according to which doctor it was. We

have a column here for it.

Q. What would you do with those summaries?

A. You mean the amounts collected?

Q. Yes.

- A. We would put that in the book and credit his account.
- Q. You don't mean the bank account of the doctor?

A. Oh, no, City Optical Company.

Q. You have some columns in that book. How would you reflect the interest of a doctor in any amount collected on those summary sheets?

(Tr. p. 397) A. Let's see if I get you straight. You

mean the amount I would pay him back?

Q. Say you sold a pair of glasses on a doctor's prescription—

[fol. 102] A. That is right.

Q. To a patient. A. That is right.

Q. Do you have any patients listed there!

A. Yes, sir.

Q. Take any patient and explain to His Honor what

happens.

A. Here is one for Mrs. Frank Joyce. We collected \$27. That amount was put in that particular doctor's column. Then we deposited \$27 in our bank account.

Q. At the end of the month what do you do with the

record there!

A. I would add the column up and pay a certain per cent.

Q. How much per cent?

A. Usually 1/3rd.

- Q. 1/3rd of the total amount credited in the doctor's column would then be paid—
 - A. To that doctor.

Q. To that doctor?

A. To that doctor, yes, sir.

Mr. Thigpen: The Petitioner offers in evidence (Tr. p. 398) this group of ledger sheets showing the daily summary of sales in order to reflect the determination of the trade discount allowed at Greensboro, North Carolina, and we propose, if Your Honor please, to further show the connection.

Mr. Maddox: Your Honor, may I ask the witness a question or two?

The Court: What is this document you are offering? There are a number of loose leaves together. What are the

[fot 103] Mr. Thigpen: A summary of the daily sales record at the Greenshoro office of City Optical Company for the month of September, 1944.

The Court: That is just an example to show how that

record was kept?

Mr. Thigpen: To also show how the determination of the amount of trade discount paid for the month of September was actually computed and determined and paid.

The Court: Is there objection to the authenticity of the

record).

Mr. Maddox: Yes, Your Honor.

The Court: Is this document kept by you or under your supervision?

The Witness: It is kept under my supervision and I have the big summary book that came out of at the office.

The Court: That is just offered as an example showing how the records are kept?

(Tr. p. 399) The Witness: Yes, sir.

The Court: You are swearing those papers were kept, that the writing was put on there under your supervision? The Witness: Yes siree.

The Court: Overruled; exception; received.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 35.)

[fol. 104] By Mr. Thigpen:

Q. Mr. Lightfoot, within the column for Dr. Taylor—A. That is here. This is it. This is designated as "T

and S" which means Taylor and Strickland., This is the first column right here (indicating).

(Tr. p. 400) Q. Mr. Lightfoot, on the inside there is a column head?

A. Doctors T. and S, which means Doctors Taylor and

Strickland.

Q. In which the amounts received or collected from patients of those doctors are recorded?

A. Yes, sir.

Q. At the end of the month did you total up the amounts credited or recorded in that column?

A. Yes, sir, I certainly did.

Q. And in the month of September, 1944, you actually made such a total?

A. Yes, sir.

Q. Then after you made the total what did you do?

A. After I made the total I wrote a check.

Q. But the total is the amount collected from the patient?

A. Yes, sir.

Q. And after you got the total amount collected from the patient, how much or what portion of the total amount did you compute?

A. I would take 1/3rd of it.

Q. You would take 1/3rd of it?

(Tr. p. 401) A. Yes, sir.

[fol. 105] Q. Have you actually recomputed one of those columns recently, or that column for Dr. Taylor!

A. Yes, I added it up, yes sir. Here is the adding

machine tape.

Q. Is that the adding machine tape upon which you totaled up Dr. Taylor's column ?

A. Yes, sir.

Q. What is the total of that column?

A. The total of the column is \$2,724.

Q. And what other figures-

A. 1/3rd of that is \$900 and that is what I paid.

Mr. Thigpen: In order to connect it up, I offer the adding machine tape which the witness has identified.

Mr. Maddox: No objection to the adding machine tape.

The Court: Received. May I ask if the total refers only to the figures contained in Exhibit 35?

Mr. Thigpen: Yes, sir.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 36.)

By Mr. Thigpen:

Q. Now, Mr. Lightfoot, on the bottom of this tape you have computed an amount. What is that amount?

A. \$908.

(Tr. p. 402) Q. Now, Mr. Lightfoot, I show you a check and ask you if that is your signature.

A. Yes, sir.

Q. What is the amount of that check?

A: \$908.

[fol. 106] Q. For what purpose was that check drawn and to whom?

A. This check was made out to cash. I took the cash and turned it over to Drs. Taylor and Strickland.

Q. Why did you get cash instead of making the check out

to Doctors Taylor and Strickland?

A. That is a custom we agreed on, no purpose whatsoever. That was agreed on and that is why we did it.

Mr. Thigpen: The Petitioner now offers in evidence this check dated October 10, 1944, for \$908, which the witness has testified represents a check which was drawn for the purpose of paying the trade discounts to Doctors Taylor and Strickland.

Mr. Maddox: No objection.

The Court: Received.

(The check referred to was marked and received in evidence as Petitioner's Exhibit No. 37.)

By Mr. Thigpen:

Q. Now, Mr. Lightfoot, that check was made out to cash, wasn't it?

A. Yes, sir.

(Tr. p. 403) Q. And you personally cashed the check? .:

A. Here is the thing about it. Most of the time I would send the girl for the amounts. Sometimes I would get

then. Whether the girl picked up the money I don't know, but I know I gave the money to the doctor.

Q. When you gave the money to the doctor what did you

get 1

A. A receipt.

Q. I show you a paper and ask you what that is.

[fol. 107] A. Yes, this was given to Dr. Shahane R. Taylor.

~Q. What does that state?

A. "Received of W. H. Lightfoot \$908, October 10, '44."

Q. That was a receipt for delivery to him of \$908 in currency which you obtained from cashing this \$908 check just identified?

A. Yes.

Mr. Thigpen: The Petitioner offers this receipt showing the payment to Dr. Taylor of these trade discounts for the month of September, 1944.

Mr. Maddox: No objection.

The Court: Received.

(The receipt referred to was marked and received in evidence as Petitioner's Exhibit No. 38.)

(Tr. p. 404) Q. Mr. Lightfoot, how widespread is this trade discount allowance business that has been testified to? Do you know of your own knowledge it has been going on for a number of years?

A. To my own knowledge it is all over the country.

Cross-examination of William H. Lightfoot.

By Mr. Maddox:

(Tr. p. 408) Q. Now, the summary daily book. Exhibit 35—which was prepared by whom did you say?

A. By my office girl.

Q. In what manner does she keep this?
[fol. 108] A. She will take the prescriptions and list them on there accordingly.

Q. Does she prepare this each day?

A. Yes, sir, each day as we went along.

Q. And this is the original record that was made for (Tr. p. 409) September, 1944?

A. Yes, sir.

Q. Now, you say this record, Exhibit 35, represents what you collected for the doctor. Is that what I understood your testimony to be?

A. For that particular month, yes.

Q. And the amount you collected for the doctor, according to this record, was the total amount you collected from the patient. Is that correct?

A. Yes, sir."

Q. If that is true, why did you deposit the entire amount

to the credit of the City Optical Company?

A. That is the way we did business. All moneys taken in for our account are deposited to the company. That belonged to the company until we turned it loose at the end of the month.

Q. Wait until I ask the question and then you can answer it. If the amount you collected from the patient belonged to the doctor, why did you deposit it to the account of the City Optical Company?

A. That is the custom we always did, at the end of the

month.

Q. For whom were you working!

A. At that time?

Q. Yes.

(Tr. p. 410) A. For City Optical Company.

[fol. 109] Q. Now, if the amount collected from the patient belonged to the doctor, why is it that you transmitted to

the doctor only 1/3rd of that amount?

A. The way I can answer that question-in a business we collect the money and deposit the money in the bank. At . the end of the month it was the custom to pay the doctor 1/3rd of that amount.

Q. When you collect from the customer the cost or price

of the finished glasses, whose money is that?

A. It is our money until we turn it loose. (Tr. p. 411)' Q. City Optical Company's!

A. That is right. If we didn't choose to pay the doctor anything we didn't have to do it.

Q. And if you said that the amount you collected from the patient was collected for the doctor, you were in error?

A. You can call it an error. We collected it for the company and we put it in his column so you would know whose account it belonged to.

Q. I asked you-

The Court: That has been answered

Mr. Maddox: May I have it asked again!

The Court: We can't see the necessity of asking the same question twice. He said if he said that he was in error period. Is that so?

The Witnessa Yes, sir.

Mr. Maddox: I take an exception to your ruling.

The Court: You may have an exception.

[fol. 110] By Mr. Maddox:

Q. What arrangements did you have with the doctors listed in this record?

A. An arrangement to dispense their glasses, deliver their glasses, take care of their payments and to collect moneys.

Q. Did you visit these doctors on occasion!

A. Yes, surely.

(Tr. p. 412) Q. What else did you do as manager of the Greensboro branch?

A. As manager of the Greensboro branch I handled it all the way through.

Q. As manager of the Greensboro branch what did you do?

A. We take care of fitting and adjusting their glasses.

Q. Did you supervise the manufacture of the glasses!

A. Yes, sir.

Q. Did you call on the doctors?

A. Yes, sir.

Q. Regularly?

A. Yes, sir.

Q. Anything else?

A. Nothing else.

Q. Now, were there any other doctors besides Doctors Tayor and Strickland who requested payment of the amount in cash? (Tr. p. 413) Q. Now, you said the practice of paying to oculists 1/3rd of the amount charged patients was wide-spread all over the country.

[fol 111] A. Yes, sir.

Q. On what basis did you make that statement?

A. I have been in the optical business for a good long while.

Q. In Newport News and Greensboro!

A. Yes, sir.

Q. Any other places!

A. No, sir.

Q. It was on a basis of your observation in those places that you make the statement?

(Tr. p. 414) A. I was assistant manager for American Optical Company and I was right up on everything concerning it.

Q. The American Optical Company is country-wide!

A. Yes, sir, branches all over the country and we received instructions out of New York for all of them.

Q. And the American Optical Company follows that practice throughout the country. Is that your understanding from year connection with the company?

A. Yes, sir.

The Court: Earlier in your examination when you were asked about the percentage paid by City Optical Company back to the several doctors—

The Witness: Yes, sir,

The Court: You said, as we recall, that that amount was usually 1/3rd.

The Witness. Yes, sir.

The Court: What was it when it wasn't \ard!

The Witness: Well, some doctors like for you to make [fol. 112] up the glasses and send them to their office and they will do their own collecting, and some doctors would let us take care of the making of the glasses, dispensing of the glasses and handling them, and they would only pay

us for the fitting charge. That is where the difference came in.

The fitting charge would make the glasses really (Tr. p. 415) cost less. In other words, the man that got the 3rd got less than the other man in the long run.

The Court: Was there any difference in that %rd pay-

ment?

The Witness: It would either be 1/2rd or it would be on a

fitting charge basis,

The Court: You said just now that either the doctor collected for himself when he did the fitting, or something else happened. What do you mean by that?

The Witness: I mean the doctor will send more a prescription. I fill the prescription and send it to his office and he would do his own collecting and I would send him a bill for

the wholesale cost.

Sometimes the doctor would have the patient bring the prescription in and I would take all measurements and that is where my fitting fee came in. There would be all adjustments with no further charge to the patient. That is where he would pay me the fee.

Direct Examination of C. E. SIMPSON, JR.

By Mr. Thigpen:

(Tr. p. 416) Q. Mr. Simpson, where do you live! [fol. 113] A. Wilmington, North Carolina.

Q. How old are you!

A. 49.

Q. What business are you in!

A. Optical work.

Q. How long have you been in the optical business?

A. Since 1918.

Q. Outline briefly to His Honor your experience in the optical business up to 1943.

A. I started in Norfolk as an apprentice mechanic. I worked to top mechanic through a large plant and wanted to consolidate my work and see if I could do it all.

I worked with Edmonds in Lynchburg. I lived at that place for a number of years, took a special course through

one of the optometrists, and had my apprentice papers for apprenticed optometry which enables me to refract

in Virginia now.

During the depression I was in business for myself (Tr., p. 417) and I had an opportunity to go to work for Tom Lilly on a 6 months' contract. I liked him and he liked me and the proposition he made me was satisfactory and I have been with him ever since. I came here as manager and worked up to general manager of City Optical Company.

Q. How long have you known Mr. Lilly?

A: Since 1930 and a knew of him or of his name, and knew his reputation since possibly 1922.

*Q. How long have you known Mrs. Lilly?

A Since possibly 1930 or 1932 or 1933, somewhere in there.

[fol. 114] (Tr. p. 421) Q. Mr. Simpson, you have been in the optical business a good many years. One of the main issues in this case is the question of trade discounts allowed to doctors. Will you (Tr. p. 422) please tell His Honor briefly what you know about that custom?

A. I have talked to optical men that travel all over the United States, Bausch & Lomb, A. O. and others. It is the general policy of the average dispensing house to operate

plants or stores more or less for the doctors.

I imagine you have in mind what we call a trade discount.

It is a national proposition.

I have talked to the old doctors that have reached possibly the age of 80. I have one in mind now that was telling me about years back when he graduated and was doing some practice, that policy was going on in those days, trade discounts to the doctors.

Q. Mr. Simpson, in the City Optical Company generally and, particularly in the Wilmington office, how are those

trade discounts determined?

A. I don't want to get pinned down too close on the book-

keeping system.

Q. Maybe I had better clear it up a little hit first. The books and records of the Wilmington Branch are not kept by you individually?

A. No, sir.

Q. Are they kept under your general supervision!

A. Yes, sir.

Q. Now, Mr. Simpson, do you know how the amount of the trade discount allowed doctors is determined?

(Tr. p. 423) A. In Wilmington it is a straight \(\frac{1}{3} \text{rd.} \)

Q. %rd of what?

A. Of the gross sales.

Q. Gross sales to whom?

[fol. 115] A. Of the glasses that the individual doctor

prescribes.

Q. Would there be any difference in the price of a pair of frames without a prescription and with a prescription from a doctor?

A. No, sir.

Cross-examination of C. E. Simpson, Jr.

By Mr. Maddox:

(Tr. p. 430) Q. In reference to the trade discounts allowed, as you call it; you said the A. O.—did you mean American Optical Company.

A. Yes. I think American handles theirs on a fitting fee

proposition.

As I say, this program over a period of years has been pretty general all over the United States. Just how the others handle it I am not positive.

Q. That has been based on what people have told you, hasn't it?

A. Yes, sir.

Q. Does the Wilmington office make eye glasses for anyone other than patients of oculists?

A. Yes, sir.

Q. And as to those what happens to the gross sales price

to the patient?

A. We manufacture them for the different doctors throughout what we might call the territory. We go down as far as Charleston and come out as far as this section of the country, and on into Elizabeth City, North Carolina.

Q. If a patient comes in to have a lens made that has been broken, what happens in that case?

A. If it is an account of ours the retailer's eredit is

[fol. 116] collected and the credit is returned back to the doctor, (Tr. 431-441) whether an O.D. on M.D.

Q. What does "O.D." mean?

A. Optomerrist.

Q. If I should have a lense made while I was here, what would happen in that case?

A. That would go in as a retail sale.

Direct examination of MILTON E. HOWELL.

By Mr. Thigpen:

(Tr. p. 442) Q. Mr. Howell, where do you live?

A. Wilmington.

Q. Wilmington what?

A. North Carolina.

Q. How old are you?

A. 50.

Q. What is your business or occupation?

A. Bookkeeper.

Q. Bookkeeper for whom?

A. City Optical Company.

Q. How long have you been employed by City Optical Company?

A. Since September, I believe, 1945.

Q. Are the books kept under your supervision or do you keep the books yourself?

A. I keep some of them myself and some are kept under

my supervision.

Q. Have you had occasion to become familiar with the books and records of the City Optical Company since you have been there?

[fol. 117] A. Yes, sir.

Q. Do you know how sales are kept track of from day (Tr. p. 443) to day!

A. Yes, sir.

Q. How are they kept track of from day to day?

A. Each day's business, the following morning is carried to the office and entered on what we call a summary sheet showing all cash receipts, charges to accounts receivable and become charges to the sales account.

Q. So you do have a daily sales summary?

A. Yes, sir.

Q. Mr. Howell, I show you these sheets that are stapled together and ask you to look at the inside front cover and tell us what is recorded herein, just briefly the nature of the transaction, not all the details. Start with the top left-hand corner over here and go straight across the page explaining to His Flonor this exhibit.

A. This is a summary sheet for January 1, 1944. The first item is cash cales of \$22.80. That is City Optical Com-

pany sales, retail sales made over the counter.

Q. The next item?

A. The next item is a sale made to Peter Jernegan in the amount of \$8 for the sale of an item made on a doctor's prescription. That Item is in the memorandum column which is carried on this and is entered as a memorandum to Dr. H. R. Coleman.

Q. Now, look at the 4th item down there and trace that (Tr. p. 444) through for us and tell us what doctor that is

credited to.

A. That is a \$5 sale credited to Dr. J. D. F. which would be Dr. J. D. Freeman.

Q. That represents what?

A. A sale made on the prescription of Dr. Freenson.

[fol. 118] Q. At the end of the month what takes place with regard to Dr. Freeman's account, for illustration?

A. These various items are entered on a list and totaled up to determine at the end of the month how much business

we received from Dr. Freeman during the month.

Mr. Thigpen: The Petitioner at this time offers, for the purpose of illustrating the determination of the trade discount to doctors, these sheets which are bound together for the month of January, 1944.

Mr. Maddox: No objection.

The Court: Received.

(The document referred to was marked and received in evidence at Petitioner's Exhibit No. 39.)

By Mr. Thigpen:

Q. Mr. Howell, have you had occasion to prepare a summary of the account of Dr. Freeman for January, 1944,

showing the sales and prescriptions to his patients recently, or have you had such a schedule prepared?

A. I have had it done.

Q. And these figures were taken off of that exhibit (Tr. p. 445) which we have already offered?

A. Yes, sir.

Q. To the best of your knowledge and belief is that a correct transcript of the entries of the column "J. D. F." in that daily summary sheet for January, 1944?

A. This is.

Q. What is the total of that daily summary sheet?

A. \$1,887.45.

Q. After that total is determined what takes place?

[fol. 119] A. We ascertain %rd of it and give Br. Freeman a check for 1/-rd for his discount.

Mr. Thigpen: The Petitioner offers in evidence the summary which the witness has identified, merely for the convenience in considering the exhibit heretofore offered, to connect up with the check which I will presently offer.

Mr. Maddox: No objection.

The Court: Received.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 40.)

Q. Mr. Howell, what was the 1/3rd amount computed on that?

A. \$629.15.

Mr. Maddox: What was the amount? The Witness: \$629,15.

(Tr. p. 446) Q. I show you a check which has been identified as Petitioner's Exhibit 22 and ask if to your knowledge that is the check that was drawn in payment of the trade discount allowed to Dr. J. D. Freeman in the amount of \$629.15.

A. Yes, sir.

Mr. Thigpen: The Petitioner new offers in evidence Exhibit 22 which has been identified by the recipient of the check, the payee, and by this witness. [fol. 120] Mr. Maddox: No objection. The Court: Received.

(The document referred to, heretofore marked as Petitioner's Exhibit No. 22 for identification, was received in evidence as Petitioner's Exhibit No. 22.)

Direct examination of CHARLES S. LOWRIMORE.

By Mr. Thigpen:

(Tr. p. 447) Q. Mr. Lowrimore, where do you live?

A. Wilmington.

Q. What business are you engaged in?

A. Public accounting.

Q. Are you a Certified Public Accountant?

A. Yes, sir.

Q. How old are you?

A. 48.

Q. How long have you been engaged in the business of accounting?

A. Since 1922.

Q. How long have you been a Certified Public Accountant?

A. Since 1932.

Q. Do you know the City Optical Company?

A. Fres, sir.

Q. Have you been employed in the auditing and examination of their books and records?

A. Yes.

Q. Do they have books and records to reflect their business transactions?

[fol. 121] (Tr. p. 448) A. They do.

Q. Are those books and records for the taxable years under consideration presently in the courtroom?

A. Yes, sir.

Q. Have you had occasion to examine those books and records for the years 1942, 1943 and 1944 for the City Optical Company and, for the years 1943 and 1944 for the Duke Optical Company?

A. I have.

Q. In your professional opinion do those books clearly and adequately reflect the business transactions of those two organizations for those years?

A. Yes, s.r.

(Tr. p. 458) Q. Mr. Lowrimore, the question of trade discounts allowed is present in this case and we want to know if in your professional examination of the books and records you found that the trade discounts allowed doctors by the City Optical Company and the Duke Optical Company, were properly reflected upon the books and records of those two companies.

A. Yes, Tr, they were.

Q. Was there a particular account on either books for

these trade discounts allowed?

A. Yes, sir, there was an account numbered 35 in the year 1942 for the Main office and each of the separate branches, called "Trade Discounts Allowed," and for 1943 and 1944 those account numbers were 315.

Q. Would that apply to Duke Optica! Company also?

A. Yes, sir, for 1943 and 1944.

Q. Upon what basis of accounting were these books kept?

[fol. 122] A. On an accrual basis,

Q. So that for each year you found accrued upon the books of account these trade discounts?

A. Yes, sir, they were even accrued monthly.

Q. I show you these papers that are bound together (Tr. p. 459) by clips or staples and ask you to look through them carefully and state if you have verified the amounts set up in those papers or on those papers, as trade discounts allowed, as having been accrued upon the books of the City Optical Company in the years 1942, 1943 and 1944.

A. We have verified these accounts and the lists as shown here are the amounts as deducted on the return and are the

amounts on the books.

Mr. Thigpen: Petitioner now offers in evidence this group of papers entitled "City Optical Company, Wilmington, North Carolina, Trade Discounts Deducted on Returns," the first page of which is a summary and the column indicated by a red pencil mark shows total trade discount

for the respective years at the respective places of business, and subsequent pages in the columns indicated by a check mark and entitled "Total Trade Discount Allowed," and running through the last figure on each page under which another red line has been placed, to show the amount of trade discounts allowed, accrued upon the books of the City Optical Company in the years under consideration.

Mr. Maddox: No objection.

The Court: Received.

(The documents referred to were marked and received [fol. 123] in evidence as Petitioner's Exhibit No. 51.)

(Tr. p. 460) Q. Mr. Lowrimore, slid you find trade discounts accrued upon the books of Duke Optical Company in the years 1943 or 1944?

A. Yes, sir.

Q. For the year 1943 I show you this schedule of such trade discounts allowed and ask you if you have checked those against the books and find that they have been accrued thereon.

A. Yes, sir.

Q. I show you the schedule for the year 1944 and ask you if you made a similar check and if you found that those amounts were accrued upon the books of Duke Optical Company for 1944.

A. Yes, sir.

Mr. Thigpen: If the Court please, Petitioner offers in evidence schedule entitled "Duke Optical Company, Fayetteville, North Carolina, Trade Discounts Allowed 1943," with particular attention to the total column which is indicated by a check mark, and the last figure at the bottom of the page which is at the bottom of that column, underscored by red pencil, for the purpose of showing trade discounts allowed as accrued upon the books of Duke Optical Company for the year 1943.

Mr. Maddox: No objection.

The Court: Received.

(Tr. p. 461) (The document referred to was marked and [fol. 124] received in evidence as Petitioner's Exhibit No. 52.)

Mr. Thigpen: Without repetition, the Petitioner offers a similar schedule for the year 1944 for the same purpose.

The Court: Is there objection!
Mr. Maddox: No objection.

The Conrt: Received.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 53.)

Direct examination of Dr. E. PREFONTAINE.

By Mr. Maddox:

(Tr. p. 490) Q. What is your profession?

A. Eye, ear, nose and throat specialist, oculist for the purposes of the Court.

The Court: Of what city are you a resident? The Witness: Greensboro.

Q. How long have you been engaged in that practice, Doctor!

A. As far as the City opticians are concerned I have been engaged since I have been established in Greensboro, but I had engaged in that practice previously with the American Optical Company.

Q. I am talking about your practice of eye, ear, nose and throat.

[fol. 125] A. Since 1931.

Q. In this proceeding the record shows that you received certain amounts from City Optical Company during the years 1942, 1943 and 1944. Can you state for the record under what circumstances you received those amounts?

A. I think that takes a little background history. The way we were operating with the American Optical Company

consisted of this-

(Tr. p. 491) Q. I am speaking with reference to City

Optical Company.

A. We have to have that too, if you will excuse me. We were told and we were shown by our records that we were paying the optician the wholesale price for glasses, that he was selling the glasses to the patient at a retail price and

giving us the difference between the wholesale price and the

retail price, what the patient paid. All right.

When the City opticians were established over here—I don't know if it was Mr. Lilly or Mr. Lightfoot who told me they were planning to start in the optical business in the city, and that they would operate under the same plan that the American Optical Company had been operating.

Does that answer your question?

Q. My direct question was the circumstances under which you received the amounts from City Optical Company.

A. I received a check every month which was the difference between the wholesale price of the glasses and the

retail price of the glasses plus a service charge.

Q. You say "of the glasses." To what do you refer? [fol. 126] A. I mean the mechanical thing, the glasses themselves, the lenses in the frames.

Q. You mean your patients' glasses?

A. My patients' glasses, the glasses that were fitted to my patients on my prescriptions.

(Tr. p. 492) Q. You say you received a payment each

month?

A. Each month by check.

Q. Was that accompanied by anything?

A. It was accompanied by a statement of which I have a copy here, which shows the price that was charged to me and the price that was charged to the patient, with the difference in the margin.

Q. Was that the custom in 1942, 1943 and 1944, to send you a statement and a check each month?

A. Yes, from 1939 on.

Q. Did you receive similar statements and similar checks from the American Optical Company, to which you refer?

A. Yes.

Q. What were the circumstances under which you received checks and statements from American Optical Company?

A. The same, a check every month with a statement.

-Q. Are you acquainted with the suit in the District Court of the United States in Chicago?

A. No, sir, I was subpoenaed—I don't know what the

legal term was.

Q. Are you the Dr. E. Prefontaine who is a defendant in that suit?

A. Yes, sir.

Q. Has the practice of these payments by optical com-[fel. 127] panies to oculists been questioned in the medical profession?

(Tr. p. 493) A. I am sorry-I didn't get that.

Q. Have these payments by optical companies to oculists

been questioned by the medical profession as a whole?

A. I have been—they are frowned upon, I would say. They are considered unethical but anything, in my estimation, that contributes to the better service to the patient and to a reduction of cost to the patient—

Mr. Thigpen: If Your Honor please, I move to strike the witness' statement that they are considered unethical. The question was with regard to whether or not they had been questioned.

The Witness: Yes.

Mr. Thigpen: There is no vidence as yet as to any action

with regard to ethics.

The Court: Not until this witness said that they were considered unethical. Motion to strike denied. Exception.

By Mr. Maddox:

Q. Doctor, where a patient comes to you for an eye examination just what does that consist of? Does he have to make an appointment with you?

A. Yes, I work by appointment.

Q. Can be make that appointment at an early date?

A. Well, i. depends. Of course, right now—it has varied any t-me from 2 or 3 days after the date of the appoint-(Tr. p. 494) ment. If I happen to have a vacancy I can [fol. 128] take him the same day and it has gone for 4 or 5 weeks.

Q. So it does require an appointment?

A. Yes, sir.

Q. Go on and tell us what the examination of the eyes consists of, in a short statement.

A. It would take a long time.

Q. I den't want you to go into detail or medical terms but tell us in medical language.

A. In my routine work it consists of seeing that the patient does not have any diseases of the eye. First you take the history, find out what the patient is complaining about and find out if it is an eye proposition he in consulting you about, and seeing there is no disease of the eye that would impair his vision, if not at the present time that might impair it later. You see that there is nothing wrong with the patient that you can determine by the eye, such as high blood pressure or diabetes—I mean excluding the pathology, as we call it, the disease.

Q. How extensive is that examination?

A. It varies. It is just looking at the patient. The history varies pretty much like the interrogation of a man on the witness stand, some have more to say than others and some tell you a whole lot of things that are irrelevant.

The length of taking the history varies with the CTr. p.

495) individual patient.

Now, I take an hour; I set aside the period of an hour for an eye examination. In many examinations if I am not interrupted I can do it in a half-hour or 45 minutes, and some more difficult cases will-take up to an hour and a half.

Q. As a result of the examination what do you do? [fel. 129] A. If treatment is necessary I prescribe treatment and if glasses are necessary I prescribe glasses.

oQ. If you prescribe glasses what do you do or tell the

patient, if anything?'

A. I tell the patient he needs glasses and I ask him if he has a choice of optician to go to, what is the choice of an optician.

Q. Is there anything else, if they have a choice or don't

have a choice?

A. If they don't have a choice I have made a practice of dividing it, City one time—we had two opticians here, the American and the City Optical Company. We still have two that I consider qualified opticians.

Q. At that point, do you tell the patient anything addi-

tional?

A. I don't tell the patient anything. I don't specify what he is going to pay for his glasses if he goes to the City Opticians or the American Optical Company which has (Tr. p. 496) discontinued that practice. I don't tell them specifically.

Q. Do you know the price which he will pay!

A. The optician?

Q. Yes. tal

A. I have it every month on the statement.

Q. I mean before the patient goes, do you know how much

he will have to pay for complete glasses?

A. I know what he has to pay for the lens. I don't know what he will have to pay for the frame because I don't know what frame he is going to select.

Q. In what manner are you informed of the cost of the

lenses?

A. If he inquires—we very seldom have an inquiry. [fol. 130] Occasionally a patient will ask "How much will that cost me," and I will say "Your lens should cost about \$13 or \$15."

Q. How are you informed as to what the cost will be to

the patient?

A. I have seen the charges over and over again.

Q. Do you tell the patient anything else at that point?

A. I tell him to be sure to come back and have his glasses checked after he gets them.

Q. After he gets the glasses does he make a new appoint-

ment?

A. No, he comes in without an appointment. He asks if he will have to have an appointment and I say "Come in at (Tr. p. 497) any time and I will see you."

Q. When he comes in who does he see!

A. He sees me. .

Q. At that point what do you do?

A. I check the fit of the glasses, check his vision again, check the grinding and check on myself as well.

Q. How extensive an examination or check is that?

A. That will take 10 or 15 minutes, hardly that in many cases. It depends on whether the patient has a single fault or more.

Cross-examination of Dr. E. Prefontaine.

By Mr. Thigpen:

Q. Do you know of any public policy that the receipt by [fol. 131] you of these trade discounts allowed, or these

remittanecs from City Optical Company that you say you have received violates?

A. Of course, we have received this summons—I think that is what you would call it—in the Federal Court in the strial against the American Optical Company and Bausch & Lomb and others.

Q. Perhaps you didn't understand my question. Do you know of any public policy that the receipt of these remittances from City Optical Company or American Optical Company (Tr. p. 498) by you violates?

A NT-

Q. Do you know of any canon of ethics of the American Medical Society or other medical societies that the receipt of such remittances violates?

A. I think that you are referring to splitting fees. The practice of splitting fees consists of dividing a fee that you get from a patient and giving part to another doctor that refers the patient to you, unknowingly to the patient. As far as this practice is concerned, I think it is generally known that it is being done, and the patient, if he wants to know it, is at liberty to know it. I don't specify the fact.

'Q. But, Doctor, there is no canon of medical ethics that the receipt of these funds by you from City Optical Com-

pany violates, is there!

A. Not to my knowledge.

Q: You stated on direct examination that the practice had been questioned? By whom?

A. It has been questioned by our state society.

[fol. 132] Q. Has there been dispositive action taken with respect to this practice?

A. They said they disapproved of it. The men have not been thrown out of the society. They said in principle they

disapproved of the thing.

Q. Dr. Prefontaine, I show you Petitioner's Exhibit 51 (Tr. p. 499) the page with respect to trade discount paid to doctors, Greensboro, North Carolina, and ask if your name appears thereon and the amount that is set up opposite your name for the year 1942.

A. 1942

Q. Not your list but this list (indicating).

A. It is on there.

Q. To the best of your information and belief, at the

18/15

present moment, you received approximately that amount in 19421

A. I think I received exactly that amount.

Q. Dr. Prefontaine, I show you a similar statement for 1944 and ask you to look at that and tell us if your name appears on that schedule.

A. Yes, at the top.

Q. Did you receive the amount set forth there of approximately that amount?

A. Yes, I would think so.

Direct examination of C. R. Mulis

By Mr. Maddox:

(Tr. p. 500) Q. What is your address, Dr. Mills!
A. Home or office!

[fol. 133] Q. Office.

A. Jefferson Building, 234, Greensboro.

Q. What is your profession?

A. Ophthalmologist.

Q. How long have you practiced that profession?

A. Since 1938 except for 3 years in the service.

Q. The record in this case shows that since 1942 you have received certain amounts from City Optical Company. Under what circumstances did you receive those amounts?

A. From glasses that my patients obtained from City

Optical.

Q. From glasses that your patients obtained from City Optical?

A. That is right.

Q. What did the amount represent that you received?

A. You mean what percentage, or the amount?

Q. What did it represent? ..

A. Per month?

(Tr. p. 501) Q. Was it the entire amount the patient paid for the glasses?

A. I expect it was around 1/3rd. I never did attempt to

figure it out.

Q. How did you receive those payments?

A. By check. av

Q. How often?

A. Once a month.

Q. Did anything accompany the check!

A. Yes, sir, a statement of each patient, the charge of the glasses retail and wholesale.

Q. Now, did you receive similar amounts from other

optical companies!

A. Just one other one. [fol. 134] Q. What other?

A. American Optical.

Q. Under what circumstances did you receive those payments?

A. The same.

Q. Are you familiar with or do you know of the suit in Chicago against the American Optical Company and representative doctors?

A. I know a little bit about it.

Q. Are you the defendant C. R. Mills in that proceeding?

(Tr. p. 502) A. That is right, sir.

Q. Mr. Mills, when a patient comes to you—first, does a patient have to make an appointment with you originally for an eye examination?

A. Most of the time.

Q. When a patient arrives what is the nature of the-

A. It depends upon the age of the patient.

Q. Tell us in a general way how the age enters into it

and what the examination consists of.

A. Every patient under the age of 45, I put drops in their eyes and dilate the pupils and paralyze the ancillary muscle. Patients over 45 I do not have to do that.

Q. Just generally what does your examination consist of?

A. Examination of the external and internal part of the eye, and refraction.

Q. How long a period of time would you say that takes

generally?

A. It depends on which is the case, whether under 45 or over. People over 45, I spend an average of 15 to 20 minutes.

[fol. 135] Q. How about under 45?

A. I spend that much more time on them the first (Tr. p. 503) time, and they come back 2 days later for a post.

Q. Those under 45—do you give them a prescription before the post, as you call it?

A. Never, because most of the time the prescription will

differ after the post examination.

Q. When you give them a prescription for glasses what

do you or what do you say to the patient?

A. I give-them their prescription and ask where they want to go to get their glasses.

Q. And if they express-

A. There are only 2 places in Greenboro, in my opinion, where you can get first-quality lenses and frames and after December 1 it was American and City Optical and now it is Stamper Optical and City Optical.

Q. Do you refer them to either one of those companies?

A. Up until December 1st I asked them which one they preferred and most of them-

Q. Going back to 1942, what did you do!

A. Most of my patients went over to American Optical Company.

Q. Did you direct them to go!

A. Well, American Optical was the one that greeted me when I first came here in 1938, so they treated me very nicely and naturally I would reciprocate.

Q. After the patient gets the glasses and returns—(Tr.

p. 504) or rather, do you tell the patient to return?

A. After they get the glasses? Q. After they get the glasses.

A. I tell them if they have any trouble or questions about [fob 136] the glasses to come back. If they are not having any trouble or question about them they do not have to return.

Q. If they do return do the make an appointment to see you!

As Most of them do.

Q. And what do you do at that time!

A. I check the prescription with my lensometer to see if what they gave them is correct. Once in a while there is a mistake. If the prescription is what I gave them, I ask them what their trouble is and try to explain to them whatthe trouble is and if I can't-

Q. You said "lensometer"!

A. That is an instrument you put the glasses on and you can determine the exact prescription.

Q. You look through this kind of microscopic affair?

A. That is right.

Q. And look through the lens that is in the glasses?

A. That is right.

Q. How long does that test of the glasses usually take?

A. About 15 seconds.

- Q. How long does the whole procedure under which (Tr. p. 505) the patient comes back to your office and that test is made amount to?
 - A. After he comes back with the glasses?

Q. Yes.

A. It depends upon what type of patient it is.

Q. Take the average patient.

A. It would take from 5 to 26 minutes.

[fol. 137] Cross-examination of Dr. C. R. Mills.

By Mr. Thigpen:

Q. Dr. Mills, I show you Petitioner's Exhibit 51 and direct your attention to the page on which appears trade discounts paid to doctors, Greensboro, 1942, and ask you to turn to the column indicated by red pencil mark and ask you to look at this schedule, the list of names and the amounts, and tell His Honor if your name appears on there.

A. Yes, sir.

Q. What amount is set opposite your name over in the column checked with the red pencil mark!

A. \$240,08.

Q. To the best of your knowledge, information and belief, did you actually receive that amount of money from City Optical Company in the year 1942?

A. I did.

Q. What did you do with that money when you re- (Tr. p. 506) ceived it? Did you put it in professional receipts and report it as income?

A. Yes, sir.

Q. When you received that money and at this time, do you know of any public policy that the receipt of such

amounts by you violates, any law, federal or state, or any other law, that the receipt of that money by you violates?

A. This morning I heard.

Q. Never mind this morning. Answer the question.

A. Up antil this morning I did not.

Q. Up until this morning you did not. Do you know now of any public policy that that violates?

A. I am not sure but I understand the suit in Chicago [fol. 138] was won by the Government. That is all I know.

Q. Do you know of any canon of ethics by the medical profession that the receipt of such amounts by you violates?

A. I think it is unethical and unprofessional.

Q. I didn't ask you what you think. I asked if you know of any canon of ethics that the receipt of these amounts violates.

A. I have never seen any canon of ethics.

Q: The medical profession has what we call in the legal profession a canon of ethics, does it not?

A. Yes.

- Q. And you have read that canon of ethics, have you not?. (Tr. p. 507) A. No, eir.
- Q. Dr. Mills, you say you have been practicing medicine and specializing in it since 1938!

A. That is right.

Q. And that you have never read the canon of ethics of the medical profession?

A. I don't believe I have.

Q. Don't you know whether you have or not?

A. I am pretty sure I never saw that.

- Q. I mean the canon of ethics of the medical profession. You have practiced now for over 10 years and you have never seen or read the canon of ethics of the medical profession?
 - A. I think when we got our M.D. that it was read to us.

Q. So you have heard the canon of ethics?

A. I have heard it-

Q. Do you-

[fol. 139] The Court: Just a minute. Let the witness answer.

The Witness: I don't remember ever deliberately sit-

ting down and reading down and reading them off one by one.

By Mr. Thigpen:

Q. Did you go to medical school?

A. Yes, sir.

Q. Did they teach ethics in medical school?

A. No, sir, not to my knowledge.

Direct examination of Dr. HUGH C. WOLF.

By Mr. Maddox:

(Tr. p. 508) Q. Dr. Wolf, will you state for the record your address?

A. Business?

Q: Business address.

A. Southeastern Building.

Q. Greensboro!

A. Yes, sir.

Q. And what is your profession, Doctor?

A. Eye, ear, nose and throat.

Q. How long have you been engaged in that practice? A. It will be 30 years the 17th of November of this year.

Q. During all of that time have you included ex- (Tr. p. 509) amination of eyes?

A. Yes, sir.

Q. When a patient comes to you for examination of eyes, does he make an appointment with you!

[fol. 140] A. Sometimes. As a rule I don't make appointments. I take the patients as they come.

Q. You don't make appointments ordinarily?

A. No.

Q. What does the examination consist of just in general terms and in layman's language, without going into too much detail.

A. You mean examination of the eyes?

Q. Yes, when a patient first comes to you.

A. Well, we first take a history on him and fine cut what the trouble is or what he is complaining of. Then we examine his vision, get his vision and, we examine him to find out if he has any pathology in his eyes and then we find out if we can improve his vision with lenses and if he needs them.

Q. How extensive an examination is that with referenge

to time?

/ A. That depends on the patient a lot of times.

Q. As a general average, as an average proposition, what is it?

A. I would say anywhere from 15 minutes to an (Tr. p. 510) hour sometimes.

Q. As a result of that examination what do you do?

A. I don't believe I understand what you want me to tell you.

Q. Do you give him a prescription for glasses if neces-

sary?

A. If he needs it, yes.

Q. When you give him the prescription do you tell him

anything!

A. I tell him this is a prescription for his glasses and he can take it over to the optical company and pick out his frames and they will make the prescription up for [fol. 141] him and when he gets them to bring them by and I will check them.

Q. Do you designate to him what optical company to take

the prescription to?

A. Sometimes I do and sometimes I don't. Sometimes they tell me where they want to go.

Q. If they don't tell you do you tell them where to go!

A. Yes.

Q. Where do you tell them to go?

A. I have been sending most of mine to the American Optical Company.

Q. After the glasses are completed and the patient gets

them, does he usually come back to yout

(Tr. p. 511) A. Most of the time they do. If they are all right some of them don't, but most of them will come back for a checkup, particularly the bifocals.

Q. That is particularly those who are wearing bifocals

for the first time.

A. Yes, sir. We have a lot of headaches with those people.

Q. When they do return do they have to make an appointment?

A. No.

Q. What does your examination consist of at that point

when he returns with the glasses?

A. I usually check the glasses to see that they are the proper strength that I ordered and I check the frame to see that it fits, and I take his vision again without the glasses and then with them.

Q. And in testing the lens to see if they are proper, how

do you do that?

A. By neutralization.

[fol. 142] Q. In what manner, with a test lens?

A. Yes.

Q. As a rule, how long does that procedure take?

A. Well, I never did-time myself on it.

Q. Is it a matter of a few minutes? Is it as extensive

as the first examination?

(Tr. p. 512) A. That depends on whether the patient is complaining of anything or not. Sometimes it takes longer to check him after he comes back and check the glasses than in the first place.

.Q. Would you say with the average patient it takes a

long time?

A. If it is a bifocal it does because you have to — practically the same thing you did the first time to see if they are right.

Q. Your first examination not only determines the lens

but also the medical examination?

A. That is right.

Q. Do you go through the medical examination?

A. I already have that. I know if there is any pathology.

Q. On the second examination about how long would

you say it takes

A. 10 or 15 minutes.

Q. In this proceeding the record shows that certain amounts were paid to you in the years 1942, 1943 and 1944 by the City Optical Company. Will you state for the record under what circumstances those amounts were paid to you?

A. I got a check at the end of the month if any of my

patients went over there.

Q. Was that check accompanied by anything? (Tr. p. 513) A. By a statement.

[fol. 143] Q. What does the amount of the check represent?

A. It represented a difference between the retail price and the wholesale price plus the fitting charge that they have. In other words, I considered the optical company acted as my agent.

Q. Was that a fixed amount or fixed percentage?

A. I couldn't say that it was exactly every time the same thing.

Q. Did it vary!

A. It was somewhere around 30 percent I would say.

Q. Now, Doctor, do you have knowledge of the suit of the United States against the American Optical Company?

A. Yes, sir.

Q. And doctors—pending in the District Court of the United States in Chicago?

A. Yes, sir.

Q. Are you the Dr. H. C. Wolfe, one of the defendants in that proceeding!

A. That is right.

Cross-examination of Dr. H. C. Wolf

By Mr. Thigpen:

Q. Dr. Wolfe, you stated that you received certain amounts from the City Optical Company. How did you (Tr. p. 514) treat those amounts on your books and records?

A. Just put it down as income.

Q. Did you report it for income tax purposes?

A. Yes, sir.

[fol. 144] 'Q. Dr. Wolfe, do you know of any public policy that the receipt of any such amounts by you violated?

A. I didn't get that.

Q. Do you know of any public policy, that is as defined by federal or state law, that the receipt of those amounts by you at the time you received them, violated?

A. No, sir.

Q. Do you know of any canon of ethics of the medical profession that the receipt of such amounts violated?

A. No, sir.

Direct examination of Dr. RALPH DEES.

By Mr. Maddox:

(Tr. p. 515) Q. Doctor, will you state your business address for the record.

A. Business address?

. Q. Business address.

A. Office?

Q. Yes.

A. Southeastern Building.

Q. In Greensborof

A. Yes.

Q. Doctor, what is your profession?

A. I am an M.D.

Q. Do you specialize in any branch of medicine?

A. Well, I do general practice.

Q. In the course of general practice do you examine eyes of patients?

Ao I used to do right much but I don't do much now. I

haven't for several years.

Q. Did you in 1942, 1943 and 1944.

[fol. 145] A. Yes, occasionally. I did some refraction.

Q. How long have you been practicing medicine, Doctor?

A. I have been practicing since 1909.

Q. When a patient comes to you for any eye examination is he required to make an appointment with you?

(Tr. p. 516) A. No, I don't have any appointment, don't

make any appointments with anybody.

Q. When a patient comes for an eye examination would you state as briefly as you can for the record the scope of that examination?

A. For an eye examination?

Q. Yes.

A. You mean for refracting?

Q. When a patient comes to you with trouble with his

eyes which results in a prescription-for glasses.

A. Well, if they come up there for eye difficulty in seeing why, sometimes I refract them if I have time. If I haven't I refer a great many of them. Most folks I refract are really folks that can't pay for glasses.

Q. I didn't understand you.

A. Most of the folks I refract are people that can't pay

for glasses. I do a lot of charity on those glasses. In fact, I have really not been refracting but very few for several years.

Q. For the record, what do you mean by refracting ?.

A. That is testing their eyes and bringing up their vision as near as we can to correction.

Q. With lenses?

A. Yes.

Q. Is that quite an extensive examination?

(Tr. p. 517) A. It takes right much time if you do it properly. That is the only way you can do it.

[fol. 146] Q. When you give a patient a prescription for glasses what do you tell him at that time?

A. I don't tell him a thing only to go ahead and take.

them to the optical company and get his glasses.

Q. Do you tell him what optical company to take them to !-

A. I have never given any choice at all to the optical companies.

Q. You have never directed them where to go!

A. As a rule, no. It is immaterial to me where they go to. There are 2 here.

Q. When they get the finished glasses do you direct them to return to you?

A. No, sir.

Q. Do they as a rule?

A. Sometimes they come by and, as a rule they don't return to me. I don't have them return to me unless there is some difficulty. If they are not seeing well, of course—

Q. Boctor, in this proceeding the record shows you were paid certain amounts during the years 1942, 1943 and 1944 by City Optical Company.

. A. Yes, sir.

Q. Will you state for the record under what circum- (Tr.

p. 518) stances you received those amounts?

A. Well, I got the amounts but I have never had any agreement with either of the companies, with the American Optical Company or the City Optical Company. I never had any agreement.

Q Under what circumstances did you receive the amounts?

A. They sent a check.

Q. Was that accompanied by anything?

[fol. 147] A. No. They have a statement on there but I have never been able to understand it.

Q. What does the amount you received represent?

A. Well, in 1943 from City Optical Company-

Q. Do you have one of the statements that you received?

A. I don't have a statement. I took this off my book.

Q. I don't want the amounts you received. I am interested in what the statement you receive from the optical company, the City Optical Company, shows.

A. That is what I was going to say. City Optical Com-

pany for the year-

Q. What information is contained on the statement you received from City Optical Company with the check?

A. On the statement—it is a sheet of paper and it gives what happened, I mean, what was done that month—

Q. What information does it contain?

(Pr. p. 519) The Court: Let the witness finish.

The Witness: They send a check showing credits. To tell the honest truth about it, I don't know how to figure it and I never have.

Q. Did you ever request the statement!

A. No, sir.

Q. Did you ever request the check?

A. No, sir.

Q. Did you receive similar checks and similar statements from the American Optical Company?

A. Yes.

Q. Now, Doctor, under what circumstances did you receive the checks and statements from the American Optical Company

[fol. 148] A. Well, just the same procedure.

Q. Do you know of the ruit of the United States against the American Optical Company and representative doctors in the District Court of the United States, in Chicago?

A. Yes, I saw that in the paper.

Q. Are you the defendant, Ralph Dees, named in that suit?

A. Yes.

Cross-examination of Dr. Ralph Dees.

By Mr. Thigpen:

(Tr. p. 520) Q. Doctor, when you got these amounts from the City Optical Company or the American Optical Company, how did you consider them and treat them on your books and records?

A. On hoy books?

Q. As professional income and receipts?

A. That's it.

Q. Did you report it in income tax returns?

A. Yes, sir.

Q. Doctor, do you know of any public policy that the receipt of such amounts by you violated?

A. No, sir.

Q. Do you know of any canon of ethics of the medical profession that the receipt of those amounts by you violated?

A. No, sir.

[fol. 149] Direct examination of Dr. Horace G. Strickland.

By Mr. Maddox:

(Tr. p. 521) Q. Will you state your address for the record, Doctor?

A. 101 North Elm.

Q. Is that your home address or office address?

A. Office.

Q. Is that in Greensboro?

A. That is in Greensboro.

Q. What is your profession, Doctor?

A. Physician.

Q. Do you specialize!

A. Eye.

Q. Any thing else?

A. I do mostly eye. I do some nose and throat.

Q. How long have you been so engaged?

A. Since 1936.

Q. When a patient comes to you for examination of the eyes, does he have to make an appointment with you?

A. Yes and no. It depends on how busy I am.

Q. Yes when and no when?

A. If we aren't busy a lot come in without an appointment.

Q. Can you state just as briefly as you can for the record

just what that examination consists of !

A. Well, we take the visual acuity and look in the (Tr. p. 522) eye grounds and check the ocular movements.

The Court: When you are describing anything of that sort please describe it in terms the layman can understand.

[fol. 150] A. We see if there is any disturbance in the motility of the eyes, the clearness of the cornea or transparent portion, the size of the pupil, whether it reacts to light and accommodation. I look to see whether the pupil moves back and forth, and then look inside the eye to see if everything is normal and have the girls put drugs in the eye that paralyzes the accommodation, and then after an hour we take them in a darkroom and finish our examination and fit lenses.

Q. How extensive an examination is that with respect to

time?

.A. It may vary anywhere from 5 to 45 minutes.

Q. Is that the original examination?

A. That is the original.

Q. If as a result of the examination you give a prescrip-

tion, what do you do or tell the patient at that time?

A. Well, we usually tell them that they can go down to the City Optical or go to the American Optical. Most of them go to the City Optical downstairs. When we give them the prescription they go where they like.

Q. In 1942, 1943 and 1944?

A. I was away during some of 1942, 1943 and 1944. (Tr. p. 523) Q. Were you here part of the time?

A. I left in September, 1942, and came back in 1945:

Q. During your practice have you been in practice with some other doctor?

A. Yes.

Q. With whom t

A. Dr. Shahane R. Taylor.

Q. How long has that partnership continued?

A. Since 1936.

Q. When the patient gets the completed glasses or rather, [fol. 151] when you give him the prescription and send him to the optician, do you ask him to return?

A. We instruct him if there is any trouble at all to come

back and let us check his glasses.

Q. Does the patient come back usually?

A. Some come back to have the lenses checked and some come back because they have some complaint.

Q: How extensive an examination do you make at that

time:

A. It depends on how [much] trouble the patient is having. If he is having much trouble it may be that we do the whole thing over again to see if a mistake has been made.

Q. In the average case what would you say the time was

that would be consumed with a patient?

A. I don't see how you can answer that with any (Tr. p. 524) degree of accuracy. I don't know how to answer that a question.

Q. Does it take a short time! Does it take as long a time as the original examination for the average patient that returns?

A. It wouldn't take as long. I just stated we might do him all over again but we don't do him all over again each time. It couldn't take as long as the original examination.

Q. In this proceeding the record shows there was paid to you and Dr. Taylor as a partnership, certain amounts during the calendar years 1942, 1943 and 1944. Will you state for the record, Doctor, under what circumstances you received those amounts from City Optical Company!

A. I don't believe I get your question.

Q. I asked you under what circumstances you received [fol. 152] certain amounts during the calendar years 1942, 1943 and 1944, or rather, the partnership of which you were a member, from the City Optical Company.

A. We received certain trade discounts during that time.

Is that what you mean?

Q. You term them trade discounts. Were they amounts of money?

A. Yes sir.

Q. In what form did you receive them?

A. I think they were all in cash. As I say, I was not here

the greater part of that time but I presume they (Tr. p. 523) were in cash.

Q. During the time you were here?

A. It was cash.

Q. Was there any reason why it was cash?

A. I couldn't answer that because I was not a partner—I don't know why—I know the first time I saw it it was cash.

Q. You were a partner in 1942, were you not?

A. I was on salary for a time. I had no prerogative as

Q. Were you on a salary in 1942?

A. No, sir.

Q. Did the partnership of Taylor and Strickland receive amounts from American Optical Company?

A. Yes, sir.

Q. Under what circumstances did the partnership receive

A. That was by gheck.

Q. Under what circumstances?

A. Trade discounts.

Q. The same as the City Optical Company?

A You mean the percentage!

[fol. 153] Q. Not the percentage but for the same reason?

A. Yes, sir.

Q. What was the percentage? Do you know?

A. You mean from American Optical? (Tr. p. 526) Q. No, City Optical Company.

A I would say the maximum was 33 and 4 3/rd, but we

didn't always get that.

Q. Do you know of the United States against the American Optical Company and representative doctors pending in the District Court of the United States in Chicago?

A. Yes, sir.

Q. Are you the Horace G. Strickland named as a defendant in that suit?

A. Yes.

Cross-examination of Dr. Horace G. Strickland.

By Mr. Thigpen:

(Tr. p. 526) Q. Doctor, you said you received, or your partnership received, trade discounts from American Optical Company and City Optical Company.

A. Yes, sir.

Q. How did you treat those trade discounts on the books of the partnership?

A. They were listed as income for the partnership.

Q. Were the amounts of those trade discounts included in the report of income to the partnership?

A. Yes, sir.

Q. As a result, when you reported your individual tax your proportionate part of the receipts was included (Tr. p. 527) in your individual tax return?

[fol. 154] A. Yes.

Q. Do you know of any public policy that the receipt of such amounts violated?

A. Do I know what?

Q. Do you know of any public policy, that is, any law of the United States or the State of North Carolina, that the receipt of such amounts violated?

A. No, sir.

Q. Do you know of any canon of the medical profession that the receipt of such amounts violates?

A. No, sir.

Direct examination of Dr. Shahane R. Taylor.

By Mr. Maddox:

(Tr. p. 528) Q. Doctor, will you state your ousiness address?

A. 319 Jefferson Building. -

Q. Greensboro

A. Yes, sir.

Q. What is your profession, Doctor?

A. Eye, car, nose and throat specialist.

Q. How long have you been so engaged?

A. Since 1924.

Q. Since 19247

A. Yes, sir.

Q. Now, do you require a patient to make an appointment with you for an eye examination?

A. Not necessarily, sir.

Q. Will you state as briefly as you can for the record what your examination when a patient first comes to you consists of?

[fol. 155] A. It consists of taking the vision primarily to see how well they read, for distance and near, taking a tactile tension on them to see if there is any tension of the eye ball, examination of the eye ball and blood vessels and see if there is any cycloplegia.

Q. Does that complete your examination at that time?

A. They are put under drops on the first visit and after about 50 minutes they are retinoscoped and then the findings are put in the trial frame and you just look for (Tr. p. 529) astigmatism, and after that if the patient is under 40 years old, or there is any reason to suspect that it might be an increase in tension in the eye since the previous examination, and then an examination with the Schott's tenonometer.

There are many varieties of tenonometers. Most are satisfactory but we use the Schott's:

Q. Would you say the examination you make at that time is quite extensive?

A. It consumes quite a bit of time.

Q. How much stime?

A. Depending on the patient. Sometimes it takes 5 or 10 minutes and sometime 35 to 40 minutes.

Q. In those cases that result in giving a prescription for glasses, what do you do when you give a prescription to the patient?

A. Well, most of the patients we give it to them, and if we don't we phone it down. Most of our business is done through City opticians.

Q. Speaking now with reference to 1942, 1943 and 1944:

A. Some are written out and same are phoned down.

Q. Back in those years is that also true, sir?

A. Yes, sir.

[fol. 156] Q. Your practice of medicine was in partnership with Dr. Strickland, was it not? A. Yes.

(Tr. p. 530) Q. How long has that partnership continued?

A. I think it began in 1936, sir.

Q. Do you direct the patient to City Optical Company in the manner you have stated, by phoning down?

A. We do, quite frequently

Q. At that time do you make any other statement to the patient?

A. Sometimes you would and sometimes they are sup-

posed to come back for a checkup.

Q. Do you usually tell them to come back for a checkup?

A. We have to have them come back for a checkup.

Q. In each case?

A. Sometimes they don't but they are supposed to.

Q. Do they more often than not don't?

A. I would say 50 percent do. I am guessing.

Q. What is the checkups they come back for!

A. We check the lens again and check the strength against the strength that was ordered, and the axis of the astigmatism, and put the patient down and see how well he reads for distance and for near.

Q. How long a time does that consume, as a rule?

A. Not long, 5 or 10 minutes maybe.

Q. Now, Doctor, in this proceeding the record shows that there was paid to the partnership of Taylor and Strickland certain amounts during the calendar years (Tr. p. 531) 1942, 1943 and 1944 by the City Optical Company. Will you state for the record under what circumstances you received those [fol. 157] amounts from City Optical Company?

A. We receive 1/3rd of the price of the glasses.

Q. The price of the glasses to whom!

A. To the patient.

Q. Whose patients?

A. My patients.

Q. Under what circumstances do you receive that 3/rd?

A. I can't understand your question, sir.

Q. Did you have some arrangement with City Optical Company?

A. We had an agreement, a verbal agreement.

Q. A verbal agreement with whom in City Optical Company

A. Mr. Lilly.

Q. Anyone else?

A. Well, he was the one I talked to. Mr. Lightfoot was there.

Q. Did you have similar arrangements with other optical companies in Greensboro?

A. American Optical.

Q. Did you receive amounts from them each month?

A. Yes, sir.

Q. And under the same circumstances?

(Tr. p. 532) A. I don't think the same circumstances. I don't know that the percentage—

Q. I am speaking now of the years 1942, 1943 and 1944.

A. I don't think the percentage was the same.

Q. Was the percentage different?

A. It was supposed to be a little larger from American Optical Company than from City. However, after many [fol. 158] years dealings with American I never was able to read the statements they sent me and neither could anyone in our office, and I don't believe you could, sir.

Q. You say the amounts received were the same except

for the percentage?"

N. Exactly the same.

Q. Now, Dr. Taylor, do you know of a suit by the United States against American Optical Company and representative doctors pending in the District Court of the United States in Chicago?

A. Yes, sir.

Q. Are you the defendant Shahane R. Taylor named in that suit?

A. Yes, sir, I am.

Cross-examination of Dr. Shahane R. Taylor.

By Mr. Thigpen:

Q. Dr. Taylor, I show you Petitioner's Exhibit 51 and (Tr. p. 533) direct your attention to the page entitled "Trade Discounts Paid Doctors, Greensboro, 1942," and ask you if your partnership appears themon listed as recipients.

A. It does, sir.

Q. How much does that statement show was paid to Doctors Taylor and Strickland in 1942?

A. \$10,095.62.

Q. To the best of your knowledge, information and belief, did you actually receive that amount of money in that year?

A. I did, sir.

[fol. 159] Q. From the City Optical Company?

A. That is correct.

Q. Now, directing your attention to a similar page for the year 1943, I will ask you if your partnership appears thereon.

A. It does, sir.

Q. How much is stated as having been paid to your partnership in 1943?

A. \$10,180,04.

Q. To the best of your knowledge, information and belief, you actually received that money from the City Optical Company?

A. That is correct.

Q. I direct your attention to a similar sheet or (Tr. p. 534) schedule for the year 1944 and ask if the name of your partnership appears thereon.

A. It does, sir.

Q. And how much is listed in the column as having been paid to your partnership as trade discounts, directing your attention to the column with the red check mark over it.

A. \$9,414.13.

Q. To the best of your knowledge, information and belief, that amount of money was received by your partnership?

A. It was, sir.

Q. How did you treat those remittances upon your books of account? Were they entered upon your books of account?

- A. They were kept as a monthly statement at the bottom of the regular journal and added into the regular income tax.
- Q. Dr. Taylor, do you know of any public policy as defined [fol. 160] by any federal or state law, that the receipt of those amounts by your partnership violated?

A. No, sir, I do not.

Q. Do you know of any canon of ethics of the medical profession that the receipt of those amounts violated?

A. No, sir. There has been some criticism but there is

criticism of everything.

Q. But you don't know of any canon of ethics of the medical profession that the receipt of those amounts violated, do you?

[fol. 161] Petitioners' Exhibit No. 19

Individual Income Tax Return 1942

Thomas B. Lilly

Trading as City Optical Company and Richmond Optical Company

Schedule of Income from Business Merchandise Sales \$370,139.77 Add—Collections on Bad Accounts Charged Off 6,543.95 Less—Sales Discounts and Allowance 63,814.36 Net Sales \$312,869.36 Net Cost of Sales 134,501.05 Gross Profit \$178,368.31 Total Operating Costs 144,187.69 Net Profit from Business \$34,180.62

PETITIONERS' EXHIBIT No. 17

Partnership Return of Income 1943

City Optical Company and Richmond Optical Company

Statement of Income and Profit for Year

Merchandise Sales	
Net Sales	\$373,471,04
Net cost of Mdse. Sold	177,037.48
Gross Profit	\$196,433.56
Total Operating Costs	160,812.52
[fol. 162] Add—Collections on Bad Account	\$ 35,621.04 its 2,887.56
Net Profit for Year	\$ 38,508.60

PETITIONERS' EXHIBIT No. 18

Partnership Return of Income 1944

City Optical Company

Consolidated Profit and Loss Statement

Sales Merchandise	Total \$466,651.64
Less: Trade Discounts and Allowances Sales Discount	60,188.26 4,006.80
	64,195.06
Net Sales	\$402,456.58
Cost of Materials Sold	212,555.57
Gross Profit	\$189,901.01
Total	171,836.12
Profit on Sales	\$ 18,064.89
Other Income Other Charges	\$ 6,744.00 809.50
Net Profit	\$ 23,999.39
Profit for Year	\$ 25,326.69

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[fol. 163] Petitioners' Exhibit No. 30	
Individual Income and Victory Tax R	Ceturn 1943
Helen W. Lilly Trading as Duke Optica	d Company
Statement of Income and Profit fo	r Year
Merchandise Sales Less—Discounts and Allowances	\$ 32,166.04 6,568.87
Net Sales	\$ 25,597.17
Net Cost of Merchandise Sold	10,303.07
Gross Profit	\$ 15,294.10
Total Operating Costs	12,900.80
Net Profit	\$ 2,893.30
PETITIONERS' EXHIBIT No. 31	
Individual Income Tax Return	1944
Helen W. Lilly Duke Optical Company	
Profit and Loss Statement	
Sales: Merchandise Less: Trade Discounts and Allowances Sales Discounts	\$ 28,489.07 4,798.35 153.23
Net Sales.	\$ 23,587.49
Cost of Materials Sold	8,473.21
Gross Profit	* 15,064.28

[fol. 1	6411	Expe	nses:
		period vehicle	Market Street, St.

	12,618.32
Profit on Sales Other Income	\$ 2,445.96
	estatus (September 1
	357.32
Other Charges	
•	99.00
Net Profit	2,704.28
Adjustments	4
	234.90
Profit for Year	2,469.38
PETITIONERS' EXHIBIT No. 40	
Wilmington Dispensing Sheet	
January, 1944	
Dr. J. D. Freeman	
	40 800
Jan. 1 Mr. L. J. Zibelin 3 Mrs. O. W. Keever	\$ 5.00 12.00
Mr Bort Jowell	99.00
Mrs. Bertha Hatcher	17.00
Bobby Jackson	11.50
Gladys Faison	
4 Mrs. Carrie West	12.00
Romona Frink	10.50
Mrs. W. N. Hasty	16.50

100		
Jan. 14	Mrs. R. H. Leggett	12.00
	Mrs. R. C. Spivéy	14.00
	Carrie Valerio	22.00
	Mrs. Hattie L. Stanley	10.00
	Mrs. Libb Moskowitz	17.00
	Mrs. Gussie Leyden	8.00
	Miss Florence Woodbay	7.00
15	Mr. G. A. Bame	9.00
	Mrs. J. W. Bland	10.00
	Mr J. T. Shepard	17.00
	Miss Tonette Compton	17.00
17	Mre I R Rrnssells	17.00
	Mrs. Jno. Ponos	5.00
	Spurgeon Baxley	6.00
% 18	Bortundo Harrison	10.00
	Mr. W. J. Mintz	12.00
	o Edward Green	13.50
[fol 166	Mrs. Mary E. Pruitt	22.00
lion ion	Mrs. C. L. DeBose	15.00
	Mrs. J. D. Elkins	1.00
19	Mrs. A. J. Gardner	15.00
	Mrs. A. T. Withrow	12.00
	Mr. Charlie Gainey	
V1.00	Ray Ganos	13.50
	Mr. S. A. Haines	:6.00
. 20	Miss M. Ketchum	29.00
	Mr. and Mrs. G. B. Squires	32.00
	L. L. Wood	10.00
	Mr. Kenneth Piner	17.00
9.	Mr. D. H. Barnett	10.00
	Miss Maggie King	17.00
	Mr. A. J. Faye	15.50
	Miss Mary Brown	17.00
	Miss Mildred Potter	15.00
	Mrs. Hattie Stanley	7.60
01		110.00
** 21	Rev. J. W. Bartin	_ 15.50
		10.40
	Mrs. J. A. Windley	22.00
	Mrs. J. A. William	8.50
	Mrs. Earl Martin	10.00
	Mrs. Chris Ganor	10.00

		131
Jan. 210	Mrs. W. E. Boyette	20.50
	Mrs. J. V. James. J. A. Leimore	2.00
22	J. A. Leimore	11.50
	Mr. O. B. Hill	19.00
1	Mr. W. G. Batson	7.00
Section 19	Mrs. Alice Kornegay	22.00
94	Mrs. R. B. Slocum Mr. Lewis Ward	20.50
42	Mrs. G. G. Thomas	7.00
	Sharon Jones	11.50
	Mr Jacob Cooper	18.50
	Mr. Jacob Cooper Bill Park	15.50
	Mr. B. D. Price	22.00
25	Emily Moore	8.50
	Mrs. J. C. Clifton	17.00
	Lee Burch	7.00
3	Billy Ezzell	8.50
	Earl Bowler	11.50
	Mr. J. O. Harwell	22.00
	Mrs. F. A. Highfall	7.00
	Mrs. E. H. Wright	13.50
	Mr. L. L. Wood	12.00
[fol. 167]	Alma Shaw	1.00
26	Mr. U. Henderson, Jr.	15.00
	Ann Avery	8.50
	H. L. Webb	7.00
	Mr. Evans Byers	17.00
	Mr. W. C. Morton	6.00 22.00
	Annie Mae Powell	17:00
	Miss Sadie Sanders	11.50
	Victor Sullivan, Jr.	3.00
0.7	Mrs. Effie Perkins	12.00
27	Mr. Vick Morris	7.00
	Celeste Eaton	14.50
, 00	Mr. E. L. Bergeman	
28	Miss Evelyn Stamper	17.00
	Bobby Soles	10.50
	Mrs. T. C. Bell	20.00
	Mr. Bloyd Sellers	5.00
-	Miss Mary Walter	15.00
	Miss Mary Walter	

132	
Jan 28 Mrs. E. J. Smith	15.00
Jan. 28 Mrs. E. J. Smith Mrs. W. W. Clardy 29 Mrs. Shirley Moore	15.00
29 Mrs. Shirley Moore	17.00
Mrs. H. Moore	9.00
Mr. H. L. Kerr	10.00
Miss Francis Penton	
Jean Westbrook	11.50
Mrs. Sam Gore	1.00
31 Mrs. J. M. Hall	17.00
Mrs. Ella Ward	
Mrs. W. H. Gaylor	25.00
Teddy Crews	
Teddy Crews	8.50
	9 - 1878 18 - 1 - 2 1
Total	\$1,887.45
· ·	
PETITIONERS' EXHIBIT No. 5	22
City Optical Company Check No. 2182	
Dated February 10, 1944	
Payable to and endorsed by	•
Dr. J. D. Freeman for	\$629.15
0 9	
[fol. 168] PETITIONERS' EXHIBIT No.	51
	4
City Optical Company	
Wilmington, North Carolin	•
Trade Discounts • • •	3
	1/00
Summary 1942	
	Trade Discount
Wilmington and Fayetteville	\$ 37,470.18
Richmond	7,307.99
Greensboro	12,285.28
	/
	[\$ 57,063.45]
Summary 1943	
Wilmington and Fayetteville	\$ 41,906.09
Richmond	7,362.10
Greensboro	12,333.76
The state of the s	Bearing the second seco
	[\$ 61,601.95]

\$37,470.18

Summary 1944

Wilmington and Fayetteville

Totals

Richmond			7,296.33 12,599.91
			(\$ 60,021.65]
		Paid to	Doctors alle—1942
	ð.		Total Trade Discount Allowed
Dr. S. E. Koonce		2 KE	
Wilmington, N. C.			\$ 3,972.25
Dr. J. D. Freeman			
Wilmington, N. C.			8,814.12
Dr. D. B. Sloan			9 - 200000
Wilmington, N. C.			7,236.08
Dr. Paul A. Z. Black			
Wilmington, N. C.	******		4.34
Dr. J. N. Robertson		N. T.	39.52
Fayetteville, N. C. [fol. 169] Dr. J. M. I.			
Fayetteville, N. C.	0.00		6,694.64
Dr. W. P. McKa		8	
Fayetteville, N. O.			5,928.71
Dr. R. T. McFadden		0	
Fayetteville, N. C.			639.64
Drs. Freeman and Co			
Wilmington, N. C.			1,813.71
Dr. H. R. Coleman		. 0	
Wilmington, N. C.			2,327.17

Trade Discount Paid to Doctors

Richmond—1942	Total Trade Discounts Allowed
Dr. W. S. Boyce Dr. E. C. Boyce	\$14.18
Dr. E. C. Boyce	4.68
Dr. A. F. Bagby	20.51
Dr. Edgar Childrey	770.80
Dr. R. H. Courtney	901.09
Dr. S. M. Cottrell	5.51
Dr. W. S. Hodnett	1.11
Dr. Francis Lee Dr. W. T. Mason	16.28
Dr. W. T. Mason	14.42
Dr. C. M. Miller	8.46
Dr. E. W. Perkins	U.UT
Dr. Walter J. Rein	908.37
Dr. Walter J. Rein Dr. G. H. Snead	329.89
Dr. Z. B. Sheppard Dr. R. C. Thomason	1,164.99
Dr. R. C. Thomason	2,975.23
Dr. R. W. Vaughn	25.34
Dr. R. W. Vaughn Dr. Pauline Williams	64.19·
Dr. W. R. Weisiger	
Dr. T. B. Weatherly	25.35
Total	\$7,307.99
	1

[fol. 170] Trade Discount Paid to Doctors

Greensboro-1942

Greensboro—1942	
	Total Trade
	Discounts Allowed
Dr. H. T. Cook	\$143.60
Dr. H. F. Pate	77.83
Drs. Banner and Banner	38.75
Dr. Ralph Dees	9 86.35
Dr. C. R. Mille	249.08
Dr. E. Prefontaine	1,370.30
Dr. H. C. Wolf	61.51
Dr. J. N. Robertson	4.03
Dr. W. C. Carr	46.76
Drs. Taylor and Strickland	10,095.62
Drs. Barnes and Farmer	94.88
Dr. Paul Stewart	7.10
Dr. Pealer	13.82
Dr. Pate	4.65
\ @	
Total \	\$12,285,28

Trade Discount Paid to Doctors

Wilmington and Fayetteville-1943

	Total Trade Discounts Allowed	
Dr. W. P. McKay Fayetteville, N. C.	\$5,812.21	
Dr. R. T. McFayden Fayetteville, N. C.	1;448.21	
Dr. J. M. Lilly . Fayetteville, N. C.	4,997.74	
Dr. S. E. Koonce Wilmington, N. C.	4,567.38	
Dr. H. B. Coleman Wilmington, N. C.	6,043.81	
Dr. D. B. Sloan Wilmington, N. C.	8,297,94	
Dr. J. D. Freeman Wilmington, N. C.	9,774.06	
Dr. R. T. Kesler Fayetteville, N. C.	796.59	
[fol. 171] Dr. W. B. Whitehead Fayetteville; N. C.	168.15	
Total	\$41,906.09	

Trade Discount Paid to Doctors

Richmon	1—1943
	Total Trade
, The Man 1971	Discounts Allowed
Dr. E. C. Boyce	\$25.54
Dr. A. F. Bagby	48.69
Dr LeC Rrawner	61.09
Dr. Edgar Childrey	1,687.49
Dr. R. H. Courtney	1,140.83
Dr. S. M. Cottrell	
Dr. Edmunds Dr. Clifford Folks	4.00 .0
Dr. Francis Lee	21.01
Dr W. T Maden	32.19
D. C M Millor	1 34 m
Dr. Watson	2.67
Dr. r. W. Feikins	
Dr. Luther Peters Dr. Walter J. Rein	2.34
Dr. Walter J. Rein	1,239.21
Dr. G. H. Snead	148.21
Dr. Z. B. Sheppard	186.52
Dr. R. C. Thomason	2,600.92
Dr. R. W. Vaughn	19.86
Dr. W. R. Weisiger	29.31 **
Dr. Pauline Williams	2.34
Dr. T.B. Weatherly	30.34
Dr. Frank Wysor	3.34
Dr. R. H. WEIGH	
Dr Woodward	90
Dr. G. Barringes Smith	0.07
Dr. J. M. Lilly	2.00
	· ·
Total	\$7,362.10

[fol. 172] Trade Discount Paid to Doctors

	Total Trade
Dr. Ralph Dees Dr. W. C. Carr Dr. H. C. Wolfe Dr. H. T. Cooke Dr. E. Prefontaine Dr. C. W. Banner	32.31 101.91 70.28 1,886.61 19.84
Drs. Taylor and Strickland -Total Trade Discount Paid to Doctor	\$12,333.76

Wilmington and Fayetteville—1944

	Total Trade Discounts Allowed
Dr. D. B. Sloan	
Wilmington, N. C.	\$7,434.53
Dr. J. D. Freeman	0.510.00
Wilmington, N. C.	8,510.96
Dr. H./R. Coleman	5 250 27
Wilmington, N. C.	5,350.37
Dr. S. Koonce	4,238.39
Wilmington, N. C.	4,200.00
Dr. J. M. Lilly Fayetteville, N. C.	4,653.11
Dr. R. C. Kesler	
Fayetteville, N. C.	3,978.96
Dr. W. P. McKay	* 501000
Payetteville, N. C.	5,946.08
Dr. W. B. Whitehead	19.01
Fayetteville, N. C.	13.01
Total	\$40,125.41

[fol. 173] Trade Discount Paid to Doctors

Richmond-1944

	Total Trade Discounts Allowed
Dr. L. C. Brawner	\$632.20
Dr. Edgar/Childrey	
Dr. F. O. Fay	
Dr. DuPont Guerry, III	720.02
D. Walton I Poin	1.785.39
Dr. G. H. Snead	130.37
Dr. L. B. Shebbard	1.0.00
Dr. R. C. Thomason	2,294.90
Total Trade Discount Paid to D	
Greensboro—1944	Total Trade
Dr. E: Prefontaine	Discounts Allowed
Dr. E: Prefontaine	\$1,841.50
Dr. H. L. Cook Dr. R. J. Pearce	351.58
Dr. R. J. Pearce	21.65
Dr. C. W. Banner Dr. Ralph Dees	31.10
Dr. Ralph Dees	97.66
Drs. Taylor and Strickland	9,414.13

Total

Dr. W. C. Carr

Dr. S. LaRose

Dr. H. C. Wolfe

\$12,599.91

756.72

78.84 6.73

PETITIONERS' EXHIBIT No. 52

DUKE OPTICAL COMPANY Fayetteville, N. C. 1943

Rebruary 19.76 220.55 202.22 \$7.33 449.8 March 10.67 2.00 224.93 393.19 630.7° April 3.33 .67 210.08 254.93 469.0 May 1.66 175.22 246.23 423.1 June 10.73 10.67 143.57 317.50 482.4 July 3.20 117.49 226.82 \$20.67 368.11 August 63.65 470.37 21.42 555.4 August 13.67 5.87 116.50 487.73 31.74 655.5 October 2.00 43.00 604.00 649.0 649.0 November 8.00 33 741.92 750.2 750.2 December 3.33 1.33 512.00 516.6 Sales discounts and adjustments 89.27 \$55.80 \$1,496.31 \$4,569.16 \$7.33 \$73.83 \$6,291.7 Cotal Trade Discount as Shown on Tax Return 9 \$6,568.8 \$6,568.8		Dr. W. P. McKay*	Dr. J. M.	Trade Disco Dr. O. L. McFayden*	Dr. R. C. Kesler*	Dr. J. F. Martin*	Dr. W. B. Whitehead*	Total
March 10.67 2.00 224.93 393.19 630.74 April 3.33 67 210.08 254.93 423 423 May 166 175.22 246.23 423 May 10.73 10.67 143.57 317.50 482.4 May 3.20 117.49 226.82 \$20.67 368.11 August 63.65 470.37 21.42 555.4 September 13.67 5.87 116.50 487.73 31.74 655.5 October 8.00 43.00 604.00 649.00 November 8.00 43.30 604.00 649.00 November 3.33 1.33 512.00 516.6 \$89.27 \$55.80 \$1,496.31 \$4,569.16 \$7.33 \$73.83 \$6,291.75 Sales discounts and adjustments Equipment bought from Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount. Fotal Trade Discount as Shown on Tax Return \$\$\text{\$\t	January	\$36.34			THE RESIDENCE OF LABOUR STREET, MICH. 4. LABOUR STREET			\$ 341.42
April 3.33 .67 210.08 254.93 469.0 May 1.66 175.22 246.23 423.1 Vane 10.73 10.67 143.57 317.50 482.4 Valy 3.20 117.49 226.82 \$20.67 368.19 Valy 63.65 470.37 21.42 555.4 Valy 63.65 470.37 21.42 555.4 Valy 70.00 43.00 604.00 649.00 Valy 70.00 43.00 604.00 649.00 Valy 89.27 \$55.80 \$1,496.31 \$4,569.16 \$7.33 \$73.83 \$6,291.7 Sales discounts and adjustments Couppment bought from Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount Total Trade Discount as Shown on Tax Return 9. \$6.568.8	February	10.67				\$7.33		630.79
May	April		.67	210.08	254.93			469.01
July 3.20 117.49 226.82 \$20.67 368.10 August 63.65 470.37 21.42 555.4 September 13.67 5.87 116.50 487.73 31.74 655.5 October 8.00 33 741.92 750.2 November 3.33 1.33 512.00 516.6 \$89.27 \$55.80 \$1,496.31 \$4,569.16 \$7.33 \$73.83 \$6,291.7 Sales discounts and adjustments \$89.27 \$55.80 \$1,496.31 \$4,569.16 \$7.33 \$73.83 \$6,291.7 Sales discount Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount 161.4 Total Trade Discount as Shown on Tax Return \$6,568.8	May					A Vant		
August 63.65 470.37 21.42 555.4 September 13.67 5.87 116.50 487.73 31.74 655.5 October 2.00 43.00 604.00 649.0 November 3.33 741.92 750.2 December 3.33 1.33 512.00 516.6 Sales discounts and adjustments Equipment bought from Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount. Total Trade Discount as Shown on Tax Return 36.568.8	June		10.67				990 67	
September		3.20						
October November . November . December		19 67	5 97					
November		10.01						649.00
December 3.33 1.33 512.00 516.6 \$89.27 \$55.80 \$1,496.31 \$4,569.16 \$7.33 \$73.83 \$6,291.76 Sales discounts and adjustments 161.4 Equipment bought from Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount 115.7 Total Trade Discount as Shown on Tax Return \$6,568.8	(1. Table 1987) - [1. 1. 1. 1. 1. 1. 1. 1. 1. 1. 1. 1. 1. 1	8 00	2.00					750.25
Sales discounts and adjustments Equipment bought from Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount Total Trade Discount as Shown on Tax Return \$6.568.8	December						f	516.66
Equipment bought from Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount. 115.7 Total Trade Discount as Shown on Tax Return		\$89.27	\$55.80	\$1,496.31	\$4,569.16	\$7.33	\$73.83	\$6,291.70
Equipment bought from Winchester Surgical Supply Co., which was furnished to Dr. R. C. Kesler and charged to trade discount. Total Trade Discount as Shown on Tax Return	Calco discounts and adjustments							161.47
Total Trade Discount as Shown on Tax Return	Equipment bought from Winchester	Surgical Supply	Co., which v	vas furnished	to Dr. R. C. K	esler and ch	arged to trade	115 70
Total Trade Discount as Shown on Tax Rectain.	discount							
	Total Trade Discount as Shown on	Tay Return		6	Y			\$6.568.87
Favetteville N C	Total Trade Discount as Bhown on	Tax Iteluin						
	* Fayetteville, N. C.	1						

[fol. 175]

PETITIONERS' EXHIBIT No. 53

DUKE OPTICAL COMPANY

Fayetteville, N. C. Trade Discounts Allowed 1944

January February March April	Dr. W. P. McKay*	Dr. J. M. Lilly* \$ 5.00	Dr. O. L. McFayden* \$ 2.08 1.33 4.67 2.33	Dr. R. C. Kesler* \$ 278.00 367.30 426.48 480.98	Total \$ 285.08 368.63 434.48 483.31
May June July August September October November December	2.34 4.00 2.34 6.34	4.54 4.00 4.67		354.31 374.45 343.14 361.87 406.72 361.80 351.50 352.74	354.31 378.99 347.14 361.87 413.73 365.80 353.84 374.00
Total amounts actually paid in year 1944. Amount accrued in December, 1944, and paid in January, 1945. Total trade discount as shown on tax returns	\$18.35	\$33.13 5.67 \$38.80	\$10.41	\$4,459.29 *** 271.50 \$4,730.79	\$4,521.18 \$277.17 \$4,798.35

^{*} Fayetteville, N. C.

[fol. 176] Tax Court—Findings of Fact and Opinion

[Syllabus]

4. The partnership owned and operated by the petitioners during the taxable years and the sole proprietorship operated as the Duke Optical Company by petitioner Helen W. Lilly are not entitled to deduct as ordinary and necessary expenses "kickbacks" or amounts credited and paid to doctors and constituting a percentage of the amount charged by such partnership and sole proprietorship to their customers who were patients of such doctors.

[Statement of Case]

Whether the optical business carried on as a partnership by the petitioners and the sole proprietorship operated by the Duke Optical Company are entitled to deductions as ordinary and necessary expenses of amounts credited and paid to doctors and constituting a percentage of the amount charged by such partnership and sole proprietorship for the manufacture of glasses for patients of such doctors.

FINDINGS OF FACT

The petitioners are husband and wife, having been magried October 2, 1937. They reside at Wilmington, North Carolina, and their returns for the taxable years were filed with the collector of internal revenue for the district of North Carolina.

[fol. 177] Petitioner Thomas B. Lilly has been engaged in the optical business since 1920. In 1922 he organized a sole proprietorship known as the City Optical Company, at Wilmington, North Carolina. Branches of this business were later, and prior to 1940, opened and operated at Fayetteville, North Carolina; Greensboro, North Carolina; and Richmond, Virginia, under the name of Richmond Optical Company.

The City Optical Company, in computing its net income, deducted the sum of payments in each year made to various

physicians specializing in care and treatment of the eye. These payments were described upon its books as "trade discounts". The basis for these payments was an agreement or understanding between such physicians and the City Optical Company that each physician, after performing service for his patient and prescribing proper lenses would, if possible, guide such patient to this optical cone pany for the work of grinding the lenses and furnishing and fitting frames. Under these agreements the City Optical Company paid to the physician in each case one third of the amount it charged his patient for the services performed. by the optical company. The patient was not required by the physician to go to a particular optical company. The relation between the patient and the physician was such that the patient would accept the suggestion made by the physician. No information was volunteered to the patient that payment was to be made by the optical company to the physician of any portion of the amount paid by him to the optical company for the service there rendered. If a patient asked whether any portion of his payment to the optical [fol. 178] company would be paid over to the physician he was told, but this occurred very rarely.

Patients were directed by the physician that when their glasses were made and fitted by the optical company to bring them back to the physician for him to check the quality and accuracy of the work done by the optical company and to see if they had been properly fitted. The work to be done by the physician on return to him by the patient might include a re-examination of the eyes of the patient if such was required. All of these services to be rendered clater by the physician were included in the charge made the patient by the physician and accordingly no additional charge was made for this service whether the patient had the prescription filled by an optical company with which the physician had a so-called "kickback" agreement or an optical company with which the physician had no such agreement. The patient in practically every instance was unaware of the fact that his physician was receiving from the optical company a portion of his payment made to that company. No witness who was asked knew of any specific canon of ethics of the various medical societies or associations for bidding this practice of oculists accepting so-called "kickbacks" from optical companies, but the practice was frowned upon and considered unethical by the medical profession as a whole. Although it had been condemned by the Medical Society of North Carolina, no direct action had been taken by that society against any individual physician. One of the optical companies in Greenshoro, North Carolina, a competitor of the City Optical Company, ceased its practice of paying these commissions or "kickbacks" to oculists [fol. 170] subsequent to the taxable years and prior to the

hearings of these proceedings.

In some cases oculist physicians did their own "dispensing," that is, they not only measured the vision and prescribed the lenses, but sent the prescription to some optical company for the grinding and fitting of the lenses to the type of frame selected by the patient, the measurements for which had been taken by the physician. On the return to the physician of the fitted lenses, these were adjusted by the physician to the patient and a total charge made for the entire service. In these cases the practice was for the physician to charge his patient the fee for the service rendered and the retail price of the lenses and Grames furnished by the optical company. The physician was then billed by and paid the optical company at the lower wholesale rate for the lenses and frame. The several state medical associations and the American Medical Association have by their canons of ethics condemned the "splitting of fees" between physicians.

The same agreement as to "trade discounts" was made and carried out under similar circumstances by the Duke Optical Company for 1943 and 1944. "Trade discounts" allowed oculist physicians by the City Optical Company for

the three years in question were as follows:

1942 \$57,063.45 1943 61,601.95 1944 60,021.65

"Trade discounts" allowed oculist physicians by Duke Optical Company for 1943 were \$6,568.87; and for 1944 were \$4,798.35.

[fol. 180]

OPINION

LEECH, Judge:

The fourth issue presents the correctness of the disallowance of deductions of certain so called "trade discounts" in computing the income of the City Optical Company and the Duke Optical Company. All of these items in each year were composed of payments made by these companies to various physicians who were oculists. These payments constituted one third of the amount these optical businesses charged customers for the grinding of lenses and the fitting of eyeglasses under prescriptions issued by those doctors. The circumstances with respect to such payments are set out in our findings of fact.

These payments for each of the taxable years have been disallowed by the respondent on the grounds that such payments were made under contracts which were void and unenforceable as against public policy and consequently are not deductible as offinary and necessary expenses.

If the payments which are the subject of the present controversy were merely remotely connected with contracts violating public policy—such as fees of attorneys paid in litigation brought to determine the question of that violation-then such payments are deductible. But if these payments were directly connected with contracts contravening the alleged public policy here—payments or the promise to make which were the very consideration for such contracts-they are not deductible as ordinary and necessary expenses. Commissioner v. Heininger, 320 U. S. 467, and cases cited therein. No question is and we think none could [fol. 181] reasonably be raised here but that the payments involved were directly connected with the contracts between the physicians and the opticians, petitioners. Petitioners' position is simply that no public policy was violated by these contracts.

Here an individual who is suffering from eye trouble employs an oculist to render professional services in the relief of that trouble. Implicit in this contract is the provision that the physician shall use his full ability and professional skill toward the patient. Ballou v. Prescott, 64

me. 305. These services include an examination and, if necessary, treatment, such as the use of glasses as prescribed by the doctor. To the patient the oculist stands in a position of the highest trust and confidence, and his advice and suggestions are customarily followed because of this status. The oculist examines the patient's eyes, measures the vision and writes a prescription for the grinding of the necessary lenses to correct the defect in sight. For this the oculist makes a charge, payment of which meets the only obligation of the patient to the oculist for the services rendered to him by the oculist, including the later service of an inspection of the quality of work in the glasses, a check of them by the oculist against his prescription and causing their return to the optician for correction where necessary without additional charge by the optician.

The oculist recommends or suggests to the patient that the prescription be taken to one or more designated opticians for the work of grinding the lenses in accordance with the prescription and furnishing and fitting frames therefor. The patient is not required to go to such opticians, but in the vast majority of cases he takes the advice or suggestion [fol. 182] of the physician, oculist, because of his trust and confidence in him.

The evidence is that certain oculists had an arrangement or understanding with the City Optical Company and the Duke Optical Company, to whom they directed their partients, that a substantial portion of the charge exacted from the patient for work done by these opticians be remitted to such oculists. The amount of the charge remitted to the oculist by the opticians here was one third of the amount paid by the patient to the optician for services rendered to the patient by the optician, which the patient employed.

Explanations by various oculists who testified in this proceeding and by officers and employees of the City Optical Company, as tending to justify the propriety of this arrangement, are anything but convincing. By some, it was stated that the optician was considered as an agent or employee of the oculist. There is, of course, no sound or even reasonable basis for such statement. The particular optician was selected by the patient, who was free to make any selection.

Others testified that the amount of the "lickback" to the oculist was his additional compensation from the optician for examining the glasses, if the patient returns to him, to learn whether the prescription has been properly filled and to cause the glasses to be returned to the optician for correction without further charge by him. Such service by the oculist, however, is included in that for which he has been paid by his patient and is performed by the oculist in all cases if requested by the patient, whether the prescription for glasses has been filled by the optician with whom the oculist has an arrangement for division of fees or one with

[fol. 183] whom no such arrangement exists.

A third explanation offered was that, in the absence of such an arrangement, an oculist might "dispense" the glasses for which he prescribed lenses. In such circumstances the oculist would not only prescribe the lenses but would have the patient select the type of frames he desired, measure his face for the size of frame necessary, and order the complete glasses, including the ground lenses fitted into the frames, from some optician employed by this oculist. He would then make an aggregate charge to the patient covering the prescription, glasses, and a charge for fitting. them when returned by the optician. It was testified that, under those circumstances, it was customary for the oculist. to charge his patient a retail price for the ground lenses and frames, while he paid the optician the wholesale price thus making an additional profit over and above that included in his charge for his prescription.

It is explained that the surrender by the oculist of the profit he would thus make, if he personally bought the lenses and frames and fitted the glasses, is the consideration for and entitles him to receive a portion of the profit derived by the optician for that service. This explanation is also without basis in fact. The employment by the patient of an optician to perform the service in question relieves the oculist not only of the work of fitting and adjusting glasses but also the burden of financing their manufacture and thus eliminates the possibility of loss to the oculist through

the patient's failing to pay for the glasses.

Public policy is defined as the public good. Everything [fol. 184] that tends clearly to undermine that sense of

security of individual rights, whether of personal liberty or private property, which any citizen ought to feel, is against public policy. Maryland Trust Co. v. National Mechanics' Bank, 102 Md. 608; 63 Atl. 70; Goodyear v. Brown, 155 Pa. 514; 26 Atl. 665; Russell v. Courier Printing & Publishing Co., 43 Colo. 321; 95 Pack 936; Boston & A. R. Co. v. Mercantile Trust & Deposit Co., 82 Md. 535; 34 Atl. 778. As the court said in Elzey v. Ajax Heating Co., 10 N. J. Misc. Rep. 281; 158 Atl. 851:

Contracts, the objects of which are regarded by common law as contrary to "public policy," are unenforceable at law.

"Public policy" has been defined as being that principle of law which holds that no person can lawfully do that which has a tendency to be injurious to the public, or against the public good, which may be designated, as it sometimes has been, the policy of the law, or public policy in relation to the administration of the law.

Thus a contract between a layman and a lawyer by which the former agrees, in consideration of a division of fees received by the latter, to seek and bring to the attorney persons having causes of action against railroad companies for personal injuries, is contrary to public policy and wold. Holland v. Sheehan, 108 Minn. 362; 122 N. W. 1.

It has been held that public policy is the community of mon sense and common conscience extended and applied throughout the state to matters of public morals, it is that general and well settled public opinion relating to man's plain, palpable duty to his fellow men, having due regard [fol. 185] to all the circumstances of each particular relation and situation. Pittsburgh, C. C. & St. L. Ry. Co. v. Kinney, 95 Ohio St. 64; 115 N. E. 505.

It has also been said that many things which the law does not prohibit in the sense of attaching penalties to punish their commission can not be admitted as the subject of a valid contract if they are so mischievous in their nature that to permit them to be the subject matter of a contract would be violative of public policy under the principle that one can lawfully do that which has a tendency to be injurious to the public welfare. Gordon

v. Gordon's Administrator, 168 Ky. 409; 182 S. W. 220; Bankers Bond Co., v. Buckingham, 265 Ky. 712; 97 S. W.

(2d) 596.

Petitioners argue that since there is no constitutional or statutory provision, State or Federal, and no canon of ethics of a medical association specifically condemning this "kickback" practice by opticians to oculists—no public policy exists proscribing such practice and therefore none is violated.

True, we have found no such constitutional or statutory provision. All the witnesses who were asked the question denied knowledge of any condemnatory specific canon of ethics although the practice had been criticized and condemned at meetings of the medical associations and in their professional publications. But is that the answer? We think not.

The absence of constitutional or statutory law or rules of professional conduct condemning this particular practice is not enough to support petitioners' position. cisions of the courts can and do evidence public policy. Vidal v. Girard's Executors, 2 Howard 127. The rule of law which the contracts between the oculists and the peti-[fol. 186] tioners violate has long ago become a fixture in the law by innumerable decisions which supply the "definite indications in the law of the sovereignty" justifying the invalidation of these contracts as contrary to the policy thus indicated. See Muscheny v. United States, 324 U S. 49. That rule of law is that one can not, at the same time, serve two incompatible masters. And actual damage is not a condition precedent to the application of the rule. Judge Lurten, while speaking for the United States Court of Appeals for the Sixth Circuit in City of Findlay v. Pertz, 66 Fed: at page 484, stated the rule as follows:

Any agreement or understanding between one principal and the agent of another, by which such agent is to receive a commission or reward if he will use his influence with his principal to induce a contract, or enter into a contract for his principal, is pernicious and corrupt, and cannot be enforced at law. This principle is founded upon the plainest principles of reason and morality, and has been sanctioned by the

courts in innumerable cases. "It has its foundation in the very constitution of our nature," says Judge Dillon, "for it has authoritatively been declared that a man cannot serve two masters, and is recognized and enforced wherever a well-regulated system of jurisprudence prevails." 1 Dill. Mun. Corp. §444: "An agent cannot be allowed to put himself in a position in which his interest and his duty will be in conflict." Leake, Cont. (3d Ed.) 409. The tendency of such agreement is to corrupt the fidelity of the agent, and is a fraud upon his principal, and is not enforceable, "even though it does not induce the agent to act corruptly." "It would be most mischievous to hold that a man could come into a court of law to enforce such a bargain on the ground that he was not in fact corrupted. It is quite inmaterial that the employer [fol. 187] was not damaged." Wald's Pol. Cont. 245, 246, note, citing Harrington v. Dock Co., 3 Q.B. Div. 549, and other cases. Taussig v. Hart, 58 N. Y. 425; United States Rolling-Stock Co. v. Atlantic & G. W. R. Co., 34 Ohio St. 450-460; Smith v. Sorby, 3 Q.B. Div. 552; Young v. Hughes, 32 N/J. Eq. 372; Yeoman v. Lasley, 40 Ohio St. 190.

Other judicial expressions of the rule are:

One employed by another to transact business for him, has no right to enter into a contract with a third person, which would place it in his power to wrong his principal in the transaction of the business of the latter, and which would tempt a bad man to act in bad faith toward his employer. • • • His compensation could be increased by such conduct, and it is no answer, that nothing of the kind occurred. [Atlee v. Fink, 75 Mo. 100]

One who is intrusted with the interest of others cannot be allowed to make the business an object of interest to himself. Such transactions are against the policy of the law. [Rezos v. Zahm & Nagel Co., 78 Cal. App. 728; 246 Pac. 564, 565]

It makes no difference that such common agent was guilty of no actual wrong. The courts refuse to coun-

tenance such an employment, not for the sake of the principals, but for the sake of the law. [Chapman v. Currie, 51 Mo. App. 40]

It is immaterial that the plaintiff acted in good faith, or that the defendant suffered no damage. It is the policy of the law to remove all temptation in an agent to be influenced by his own interest to the detriment of his principal. [Humphrey v. Eddy Transportation Co., 107 Mich. 163; 65 N. W. 13]

[fol. 188] See also Oscanyan v. Arms Company, 103 U. S. 261; Tool Company v. Norris, 2 Wall. 45; Easton Tractor & Equipment Co., 35 B.T.A. 189; Quinn v. Burton, 195 Mass. 277; 81 N. E. 257; Smith v. David B. Crockett Co., 85 Conn. 282, 82 Atl. 569; Jensen v. Bowen, 37 N. D. 352, 164 N. W. 4.

This rule has been recognized and applied by this Court. Not only is that true, but it has been extended to cover a case where the proscribed contract was made not by the principal with the agent or employee of another principalbut by one principal with an intimate friend and associate of the agent or employee of the other. Thus in Easton Tractor & Equipment Co., Inc., supra, the petitioner sought to deduct, as ordinary and neces ary expenses of its business of selling road equipment, commissions paid to a person, not a public official, who was a friend and associate of members of the State Highway Commission, who were agents and employees of the State in the purchasing of such equipment. We denied the deduction on the ground that the contract under which it was paid was against public policy.

In this case, as in others cited, the agent or employee involved was that of a government or its instrumentality. But the rule is applied generally to situations where the parties are private individuals or corporations. Maryland Trust Co. v. National Mechanics' Bank, supra; Wolfe v. International Re-Insurance Corp., 73 Fed. (2d) 267; certiorari denied, 294 U. S. 725. See also United States v. Carter, 217 U. S. 286.

¹ In neither the Wolfe nor Beekman case did the decision rest on the violation of any statute.

In the Wolfe case the plaintiff, a public accountant, was [fol. 189] employed by both the United States Casualty Company and the defendant corporation to make their annual audits. In connection with this audit of the United States Casualty Company he called attention of its president to the amount of its outstanding risks as being too high and recommended the reinsurance of a portion of them with the defendant. Unknown to United States Casualty Com- . pany, Wolfe had an agreement with the defendant for the latter to pay him a commission on all business United States Casualty Company should reinsure with it. Wolfe drafted for the latter company a reinsurance contract and participated in the conference between the two companies as a result of which it was adopted. In holding the contract between Wolfe and defendant void and unenforceable, Judge Learned Hand, for the Circuit Court of Appeals for the Second Circuit, said the contract "made impossible that unmixed allegiance on which the law insists."

In Reilly v. Beekman, 24 Fed. (2d) 791, the facts were these. Reilly was an accepted business and financial adviser to one Mrs. Trenkman, and as such occupied a position of trust and confidence. Mrs. Trenkman had a business'matter involving her father's estate and Reilly advised her to employ Beekman, a lawyer to represent her. Reilly introduced Beekman to her, as a result of which Beekman was employed. Unknown to Mrs. Trenkman, Really had an agreement with Beekman under which he was to receive 50 per cent of any fee received by Beekman on business which Reilly might be able to direct to him. Beekman received from Mrs. Trenkman a fee of \$600,000 for his services to her. Reilly sued Beekman for the percentage due him under their contract. In denying relief on the ground [fol. 190] that the contract between Reilly and Beekman was void as against public policy, the Second Circuit, speak-

ing through Judge Augustus N. Hand, said:

It cannot be disputed that, if Reilly was in a fiduciary relation to Mrs. Trenkman when he recommended Backman fr her as an attorney, he could not agree to profit from the business arising out of the introduction without her knowledge and consent. This is because Mrs. Trenkman was entitled to his disinterested advice

as to the attorney to be recommended to ber. That advice was not likely to be disinterested, if affected by the consideration of whether or not he could make a profit out of the recommendation of a particular person. Moreover, she was entitled to have him recommend an attorney, the amount of whose fees would depend on the services he had to perform, and would not be affected by what he had to pay out to the plaintiff for an introduction to the client.

The court said further:

an ordinary sense as an agent for Mrs. Trenkman is respect to her business and financial affairs, and simply as a friend recommended a lawyer, when requested so to do, we think he stands in no better position. To be sure, in that case he would be only a volunteer; but if he offered merely as a friend to recommend an attorney, with no knowledge on her part that he was to derive any benefit from the recommendation, she was deprived of the disinterested advice which he assumed to give when he was under the pay of Beekman in making the recommendation.

on truct on which recovery is sought as unenforceable, because against public policy. • • [Italics supplied.]

[fol. 191] It is not contended by the petitioners, nor did any witness testify, that the aggregate fees of the oculist and the optician or even the cost of glasses to a patient was, less or no more under the above "kickback" arrangement than it would have been in its absence. It is clear to us that the practice tended to increase that cost. The oculist of course knew of his contract with the optician when each patient was examined. The patient, in practically all cases, knew nothing of the arrangement. Thus, the oculist, in a relationship of great trust and confidence with respect to the patient, is subjected to the temptation of prescribing glasses where not actually necessary, or more expensive lenses than those really needed.

It may be argued, however, that such rule is not applicable on the present facts for the reason that the contract of employment between the oculists and their patients ceased with the issuance of the prescription for glasses to the patient and therefore did not include any recommendation of an

optician by the oculist. We disagree.

The patient employed the physician, oculist, to use his full professional care, ability and skill in attempting to cure or relieve the patient's eye trouble. Ballouv. Prescott, supra. Under the express terms of this contract these services did not terminate until after the patient received his glasses from the optician when, if requested by the patient, the doctor was required to inspect and check them against his prescription. Thus, we think, the contract of the doctor with the patient included the full use of his professional skill, ability and care in providing a proper grinding of the necessary lenses as prescribed by the doctor which, in turn, comprehended—at least when made as here -recommendations as to the optician the patient should [fo]. 192] employ. See Reilly v. Beekman, supra; Schmit v. Esser, 183 Minn. 354; 236 N. W. 622. To the same effect are Gillette v. Tucker, 67 Obio St. 106; 65 N. E. 865; Nash v. Royster, 189 N. C. 408; 127 S. E. 356.

Although the pertinent rule or policy of the law, as has been stated, is a fixture in the law, we have found no case where it has been applied to the present facts. This is understandable. The two apparent ways in which the question could arise on these facts would be where a physician was suing on such a contract or where, as here, the optician attempts to deduct his payments under such contract as ordinary and necessary expenses of his business for tax purposes. In the first case it is improbable that any sensible doctor would sue and thus allow the attendant publicity of his lack of professional honesty to lose him more than the money involved. In the latter case, if the payments by the opticians to the doctors were camouflaged as here, under the inaccurate designation of "trade discounts," it would be at least difficult for the tax collecting agency to discover such

payments.

Nevertheless, we think the answer is clear. So far as this record reveals, all the contracts under which these "kickbacks" were paid were made by petitioners with physicians. We think petitioners knew that fact and realized the very high degree of trust and confidence ex-

isting between those doctors and their patients. We think petitioners realized that because of that because of that relationship the patients would follow the recommendation of the optician by the doctor, as they did, and that these considerations were what inspired the petitioners, opticians, to make these contracts and the payments, the deduction of which is in controversy. It may be noted further that these contracts were oral-so far as here disclosed; that [fol. 193] the payments to some of the cenlists were made in each at their request and, significantly, all such payments were recorded in the books of petitioners under an account labeled "trade discounts"-an account which obviously, to say the least, did not correctly describe them. To which may still be added the fact that one of the two opticians in Greensboro, North Carolina, where this case was heard, has ceased this "kickback" practice since the tax years involved here.

If we accept the contract between the doctor and the optician on its face, it would seem that the payments thereunder to the doctor were merely commissions on the sale of lenses and frames of the optician to the patient of the doctor. On this basis the doctor, unknown to the patient, is accepting a payment from the optician for recommending the optician-a service which is included in the employment of the doctor by the patient and for which the doctor has been paid by the patient. But some of the doctors testifying insisted the payments they received from the opticians, unknown to the patient, were additional compensation for the services to be rendered to their patients in checking and inspecting the glasses after their delivery to the patients. It is not disputed, however, that this check and inspection of the glasses purchased from the optician on the recommendation of the doctor were included in the employment of the doctor by the patient for which the patient had paid the doctor. Nor is it to be questioned that, under his contract of employment by the patient, it was the duty of the doctor, where necessary-after this inspection of the glasses-to direct their return for correction to the optician whose contract with the patient required the optician to do this addi-[fol. 194] tional work on the glasses without additional charge.

Thus under either premise-and approaching the question from the viewpoint of either the physician or the optician—the contracts between them violated the rule of public policy above discussed. Wolfs v. International Reinsurance Corp., supra; Reilly v. Beekman, supra; Easton Tractor & Equipment Co. Inc., supra; Kelley-Dempsey & Co., 31 B. T. A. 351. In the last cited case a contractor doing work for a principal agreed to pay agents of that principal who were employed in inspecting and approving the work to see that the contractor received that to which he was entitled under the contract. In that case there was no indication that the principal was actually defrauded or that the inspection was other than honest and fair. No indication of any intention to corrupt the agent and induce him to approve work improperly done appears. There, however, we characterized such a payment as one by which the contractor "greased some palms," and denied the deduction of the payments thus made by the contractor as not ordinary and necessary business expenses.

It is true that the evidence in this case is that the practice questioned here was more prevalent than that condemned in the Kelley-Dempsey case. But the fact that more people "greased [more] palms" here than in the Kelley-Dempsey case, whatever its other effects are, surely does not make of such practice anything other than a greasing of palms. We continue to hold, as we did in the Kelley-Dempsey case,

that

* * * to encourage the accession to demands of this sort, both morally and legally wrongful, by straining the common meaning of the words of the statute to permit such payments to be deducted as ordinary [fol. 195] and necessary expenses of operating a business would be poor public policy. This Board and the Courts have consistently refused to do so with respect to expenditures occasioned by somewhat comparable causes.²

[Footnote 2-citing cases]

It must be remembered that the fundamental principle with which we are dealing here is not that of the relationship between the parties to an ordinary commercial transaction. We are concerned in this case with the relationship between physicians and their patients. There can be no doubt of the exceedingly high degree of confidence and trust inherent in that relationship.

As the court in a recent exhaustive and illuminative discussion of that relationship said in Bartron v. Codington County; 68 S. D. 309, 2 N. W. (2d) 337:

These professions, as they exist in our social structure, rest upon a foundation of sturdy, sterling human character which, in turn, has been and is being shaped and moulded by the impact of traditional ideals and points of view. The licensing statutes with their emphasis on character and professional conduct evidence a fixed public desire and will not only to foster, but to develop and reinforce, these basic attributes of its professional servants. The constant trend of public demand, as exhibited by these licensing statutes, is for mounting standards, a more painstaking investigation of the character and professional conduct of applicants for entrance into those regulated fields, and a more constant vigilance in observing the conduct of those to whom the privilege of practice has been Manifestly, that which has a tendency to blight the character or lower the standards of the business or professional practice of these individuals would be in contravention of the public aspirations so [folo196] clearly reflected in the licensing statutes. Thus we conclude that debasement of the professions is not only inimical to public welfare in fact, but is in contravention of an established and fixed community want.

It may be argued that the result of this conclusion is to penalize the opticians who make the payments which are the subject of this controversy—and leave untouched the doctors who receive them and whose professional ethics are involved. This may be the fact. But the opticians are, as has been fully demonstrated, far from blameless. If the present contracts between the petitioners, opticians, and the doctors are void as against public policy, then payments made under these contracts, regardless by

which party thereto, are not deductible as ordinary and necessary expenses. Cf. Wolfe v. International Re-Insurance Corp.; supra; Reilly v. Beekman, supra; Easton Tractor & Equipment Co., Inc., supra; Kelley-Dempsey & Co., supra.

We conclude that the payments under the contracts between the two optical businesses, composed of petitioners, and the oculists are not deductible as ordinary and necessary expenses because the contracts under which these pay-

ments were made violated public policy.

Reviewed by the Court.

Decisions will be entered under, Rule 50.

APUNDELL, J., dissenting:

I am disturbed by the holding in the majority opinion that a commission (characterized as a "kickback") paid by an optician to a doctor for sending him customers may not be deducted as an ordinary and necessary expense on [fol. 197] the ground that this practice of the doctors is unethical and contrary to public policy. The question seems

to be one of first impression.

The revenue statutes are designed to traise money to support the Government and as stated by Judge Sibley in Alexandria Gravel Co. v. Commissioner, 95 Fed. (2) 615, they are none to squeamish about how the income to be taxed was realized. The profits of illegal businesses are taxed the same as the profits of legitimate businesses and as the tax is based on net income rather than gross income, the expenses incurred in carrying on of the illegal business have been generally allowed, as the purpose of the tax laws is not to penalize a business because it is one on which the law frowns. Commissioner v. Heininger, 320 U. S. 467. It is true that courts have balked at permitting the deduction of sums paid as bribes and sums paid to perform an act specifically forbidden by law, but those holdings were based on the finding that such expendi-

tures could not be characterized as "ordinary" or "necessary" in the carrying on of a trade or business."

Our income tax system is what is commonly called a self-assessing one and the deductions to be allowed are the ones spelled out by Congress. Expenditures incident to the earning of the income arc. generally speaking, deductible in determining the income to be taxed. As I understand the holding of the majority, it is that what would be normally regarded as an ordinary and necessary expense may not be deducted in this case because the arrangements incident to the payment are said to be contrary to public policy.

There are many definitions of what is public policy, and Words and Phrases, Vol. 35, pp. 274-291, contains hundreds of excerpts from court decisions defining the [fol. 198] form and some of the definitions as quoted in the majority opinion are to be found in this work. In Vidal, et al. v. Girard's Executors, 2 How. 126, 197, where certain conditions which had been attached by a testator to a devise for the establishment of a college were challenged as being violative of the public policy of Pennsylvania, the Supreme Court held:

In considering this objection, the court are [sic] not at liberty to travel out of the record . . . to consider whether the scheme of education by him prescribed, is such as we ourselves should approve, or as is best adapted to accomplish the great aims. and ends of education. Nor are we at liberty to look at general considerations of the supposed public interests and policy of Pennsylvania upon this subject, beyond what its constitution and laws and judicial decisions make known to us. The question, what is the public policy of a state, and what is contrary to it, if inquired into beyond these limits, will be found to be one of great vagueness and uncertainty, and to involve discussions which scarcely come within the range of judicial duty and functions, . . . We disclaim any right to enter upon such examinations, beyond what the state constitutions, and laws, and decisions necessarily bring before us.

More recently, in Muschany v. United States, 324 U. S. 49, 66, the Supreme Court has stated:

Public policy is to be ascertained by reference to the laws and legal precedents and not from general considerations of supposed public interests. Philadelphia, 2 How. 127, 197-98. As the term "public policy" is vague, there must be found definite indications in the law of the sovereignty to justify the invalidation of a contract as contrary to that policy.

[fol. 199] It would seem to me that the Tax Court should be reluctant to undertake the determination of the questionof what is and what is not contrary to public policy, both for the United States and for each of the 48 states, where the act condemned as against public policy is not one shown to be violation of any law of the land. What are deductible items should be known to a taxpayer with reasonable certainty under our income tax system. This Court in the past has taken the position that it does not possess the right. to condemn undesirable trade practices as being against public policy where it could find no expression of statutory law or other authority to that effect. See F. L. Bateman, 34 B.T.A. 351.

It is interesting to note that the Commissioner in his Regulations does not point out that expenditures of this sort fall without the purview of the statute, and in his brief in this case he does not argue that the agreements between petitioner and the doctors were contrary to public policy, but, rather, that the payments to the doctors are not ordinary and necessary expenses in that they were volun-

tary and incident to an unethical practice.

DECISIONS

Docket No. 18881:

This proceeding came on to be heard at Washington, D. C., July 27, 1950, under Rule 50, both parties having filed recomputations of the deficiencies upon the basis of the opinion of this Court premalgated June 6, 1950, those computations not being in agreement.

Upon examination of the recomputation prepared by each party and upon careful consideration of the explanation and arguments of counsel, it is determined that the [fols. 200-201] recomputation as made by the respondent is correct. It is, accordingly,

Ordered and decided that there are deficiencies in income tax due from the petitioner for the years and in the amounts as follows:

Year 1943 1944 Deficiency \$54,953.67 19,301.68

(S.) J. Russell Leech, Judge:

Entered Sep. 6, 1950.

Docket No. 18882:

Pursuant to the findings of fact and opinion of the Court promulgated in the above-entitled proceeding on June 6, 1950, the petitioner filed on July 7, 1950, her proposed computation, and respondent filed on July 21, 1950, his proposed computation herein, which computations are in agreement. It is therefore,

Ordered and decided: That there are deficiencies in income tax for the years 1943 and 1944 in the amounts of

\$26,685.29 and \$23,167.14, respectively.

(S.) J. Russell Leech, Judge.

Entered July 24, 1950.

As corrected by order dated July 26, 1950.

[fol. 202] APPENDIX "B" TO RESPONDENT'S BRIEF

RESPONDENT'S EXHIBIT T

IN THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

Civil Action No. 46C1333

UNITED STATES OF AMERICA, Plaintiff

AMERICAN OPTICAL COMPANY, an Association; AMERICAN
OPTICAL COMPANY, a Corporation; Noah Fox; G. H.
Mundt; A. J. Blickenstaff; Steve A. O'Brier; Loran M.
Martin; Herman C. Kluever; Charles H. Coughlin;
Frank C. Boggs; M. E. Brownell; W. O. Quiring; J. D.
Woolworth; N. T. Simmonds; E. J. Curran; Joseph S.
Summers; William Orlando Smith; John J. Crume;
Frederic J. Crumley; Bernard B. Friedman; Fred R.
Landon; H. J. Heeb; Reinhold O. Ebert; Erwin W. Newman, Defendants

COMPLAINT

The United States of America, by its attorneys, acting under the direction of the Attorney General brings this complaint against the defendants named herein, and upon information and belief alleges as follows:

I

JURI DICTION AND VENUE

1. This complaint is filed and these proceedings are instituted under Section 4 of the Act of Congress of July 2, 1890, c. 647, 26 Stat. 209 (15 U.S. C. 4), as amended, said Act being commonly known as the Sherman Antitrust Act, against the defendants named herein, in order to prevent and restrain violations by them of Section 1 (15 U.S. C. 1) of the said Act.

2. The defendant corporation, American Optical Company, transacts business within the Northern District of Illinois, Eastern Division, and is found therein.

DEFENDANTS

Corporations and Associations.

3. American Optical Company, named herein as defendant, is a voluntary association organized under the laws of the State of Massachusetts and has its principal place

of business at Southbridge, Massachusetts.

4. American Optical Company, named herein as defendant, is a corporation organized under the laws of the State of Massachusetts and has its principal place of business at Southbridge, Massachusetts, in the same buildings used and occupied by the American Optical Company (an association). The defendant corporation is a wholly owned and controlled subsidiary of American Optical Company (an association) and was organized by the said defendant association to distribute ophthalmic goods in States having state or restrictions as to voluntary associations of the type permitted under the laws of the State of Massachusetts.

5. Whenever herein the term "defendant American" is used, it shall be understood to refer to American Optical

Company, the association and the corporation.

Class Defendants

6. The following individuals and the class of persons to which they belong are named as defendants. The individuals designated as defendants are fairly and adequately representative of a class of persons so numerous as to make it impracticable to bring all of them before the court; and against whose members the character of right sought to be enforced is several, and there are common questions of law and fact affecting their several rights and a common relief is sought against all the members of the class:

Name: Address:

Noah Fox, M.D., 841 East 63d St., Chicago, Ulinois.

C. W. Murds, M.D., 20 North Michigan Avenue, Chicago, Ulinois.

Ulinois.

A. J. Blickenstaff, M.D., Alliance Life Bldg., Peoria, Illi-

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Name: Address:

Steve A. O'Brien, M.D., First National Bank Bldg., Mason City, Iowa. [fol. 204] Loran M. Martin, M.D., 711 Carver Bldg., Fort Dodge, Iowa.

Herman C. Kluever, M.D., 711 Carver Bldg., Fort Dodge,

Chas. H. Coughlin, M.D., 711 Carver Bldg., Fort Dodge, Iowa,

Frank C, Boggs, M.D., 600 Mills Bldg., Topeka, Kansas. M. E. Brownell, M.D., 1025 First National Bank, Bldg., Wichita, Kansas.

W. O. Quiring, M.D., c/o fage Hall Clinic, Hutchinson,

Kansas.

J. D. Woolworth, M.D., 1514 Slattery Bldg., Shreveport, Louisiana.

N. T. Simmonds, M.D., 1240 Jackson St., Alexandria, Louisiana.

E. J. Curran, M.D., 1805 Federal Reserve Bldg., Kansas City Missouri.

. Joseph S. Summers, M.D., 234 Madison St., Jefferson City, Missouri.

Wm. Orlando Smith, M.D., 203 Phileade Bldg., Tulsa,

Oklahoma. John J. Crume, M.D., Fisk Bldg., Amarillo, Texas.

Frederic J. Crumley, M.D., Fisk Bldg., Amarillo, Texas. Bernard B. Friedman, M.D., 916 Jones Bldg., Corpus Christi, Texas.

Fred R. Landon, M.D., Hamilton Bldg., Wichits Falls,

Texas.

H. J. Heeb, M.D., 813 West Wisconsin Ave., Milwaukee, Wisconsin.

Reinhold O. Ebert, M.D., 64 Mount Vernon St., Oshkosh, Wisconsin.

Erwin W. Newman, M.D., 1606 Capitol Ave., Cheyenne, Wyoming.

7. The class of persons made defendants herein, of whom the foregoing individual defendants are members and are fairly and adequately representative, have the following things in common:

(a) All are physicians (commonly known as oculists) who specialize in the science of the eye and its diseases; (b) All, in their professional capacity, regularly make ophthalmic refractions for their patients, and on the basis of such refractions prescribe ophthalmic lenses for the patients' eyes;

(c) All regularly charge patients a professional fee for making ophthalmic refractions and for prescribing

the type and power of ophthalmic lenses needed;

(d) All refer patients to or have patients who take their prescriptions for ophthalmic lenses to a dispensing branch of defendant American to purchase spectacles or parts thereof as prescribed;

(e) All receive and accept from defendant American rebates or "credits" of part of the purchase price

paid by patients for spectacles and parts thereof.

8. The defendant American, through its dispensing branches, fills prescriptions for patients of upward to three [fol. 205] thousand oculists in the foregoing class, with each of such oculists receiving and accepting relates or "credits" from the defendant American on account of ophthalaic goods sold to the patients of such doctors.

JIII

DEFINITIONS

9. "Oculist." This term when used in this complaint applies to physicians (M. D.'s) specializing in the science of the eye and its diseases. Doctors who have had advanced training in this field are professionally known as ophthalmologists. Oculists in their professional capacity make ophthalmic refractions (commonly known as eye examinations) for their patients and prescribe ophthalmic lenses to correct deficiencies in vision.

10. "Optometrist." This term when used in this complaint applies to persons who are not physicians (M. D.'s) but who are licensed by the States to examine human eyes, make ophthalmic refractions and prescribe ophthalmic

lenses to correct deficiencies in vision.

11. "Wholesaler." This terms when used in this complaint applies to a person, company, or branch thereof, in the optical supply business, who maintains a stock of lenses, blanks, semi-finished lenses, frames, mountings, and other parts needed for use in making complete spectacles or repairing spectacles, together with machinery and equipment for grinding, polishing, edging, beveling, and mounting lenses, and who sells such ophthalmic goods to oculists and optometrists and opticians on a "stock," "Rx," or "prescription" basis. Many of such wholesalers sell spectacles or parts thereof directly, on prescription from oculists of

optometrists, to their patients.

12. "Retail Optician." This term when used in this complaint applies to any person or company who maintains a stock of lenses, blanks, semi-finished lenses, frames, mountings, and other parts needed for use in making com-[fol. 206] plete spectacles or repairing spectacles, together with machinery and equipment for grinding, polishing, edging, beveling, and mounting lenses, and who sells spectacles and parts thereof on prescription to the patients of ocalists, but does not make a practice of making Rx, or prescription sales to oculists or optometrists. Retail opticians who are members of the "Guild of Prescription Opticians of America, Inc.," and are commonly known as "Guild opticiafis" are pledged by their code of ethics to give no rebates or "credits" to doctors of any part of the purchase price a paid by their patients to such Guild opticians for spectacles or parts thereof.

13. "Stock Sales." This term when used in this complaint applies to bulk or quantity sales of ophthalmic goods such as lenses, frames, mountings, and other parts used in making a complete pair of spectacles, by wholesalers to oculists, optometrists, and retail opticians. Most of such sales are made by wholesalers to those who have the equipment and skill or trained personnel needed for grinding, polishing, edging, beveling, drilling, and mounting lenses.

14. "Stock Prices." This term when used in this complaint applies to the range of wholesale prices charged by wholesalers for the different quantity categories which they set forth for stock sales of ophthalmic goods. These stock prices are the lowest in the category of wholesale prices charged by wholesalers.

15. "Rx" or "Prescription Sales." Either of these terms when used in this complaint applies to sales made by wholesalers to oculists and optometrists on their prescriptions of single units (or pairs when the unit is in that

form) of ophthalmic goods. The term when applied to lenses refers to those which have been ground to the power specified by the prescription and otherwise prepared and

ready for mounting or actually mounted.

16. "Rx" or "Prescription Prices." Either of these terms when used in this complaint applies to the prices charged by wholesalers to oculists and optometrists on Rx or prescription sales. These terms when applied to [fol. 207] ophthalmic lenses cover the prices for such lenses ground to the prescribed powers and otherwise completed and ready for mounting or actually mounted. The Rx or prescription price on a completed pair of spectacles is arrived at by adding the Rx or prescription price of the prescribed lenses, ready for mounting or mounted, to the Rx or prescription price of the mountings used with these lenses to make the complete pair of spectacles. Rx or prescription prices are the highest in the range of prices charged by the wholesaler to oculists and optometrists.

17. "Dispensing." This term when used in this complaint applies to the sale to a patient of the prescribed glasses, parts, or repairs, the sale usually involving fitting.

and adjusting the glasses to the patient's face.

18. "Wholesale Dispensing." This term when used in this complaint applies to the dispensing by wholesalers directly to patients of oculists, on prescriptions, of spectacles and parts thereof, including single lenses or pairs of lenses prescribed to repair broken lenses or replace lenses. Wholesale dispensing, as practiced by the defendants, will be more fully described hereinafter.

IV

Trade and Commerce

19. The defendant American manufactures a full line of ophthalmic goods consisting of ophthalmic lenses in blank, semi-finished and finished form, frames, mountings, and other parts for complete spectacles in its factories located in Southbridge, Massachusetts, and other places. It is one of the two largest manufacturers of ophthalmic goods in the United States. The defendant American ships ophthalmic goods manufactured by it to its wholesaling branches, including those branches located in States other

than the States in which the ophthalmic goods are manufactured. The defendant American operates approximately 254 of such wholesaling branches distributed as fol[fol. 208] lows in the designated States, the District of Columbia, and the Territory of Hawaii:

a 110 - 11		
California	20	Maine 4
New York	20	New Jersey 4
	20	West Virginia 4
Massachusetts	12	Virginia4
Illinois	10	South Carolina 3
Iowa	10	Kentucky 3
Missouri	10	Arkansas
Ohio	10	Mississippi 3
Pennsylvania	8	Montana 3
Florida	8	Idaho 3
North Carolina	7 .	Minnesota 2
Tennessee	6	Utah 2
Indiana	6	South Dakota 2
Washington	6	Arizona 2
Louisiana	6	Wyoming 1
Wisconsin	5	New Mexico 1
Kansas	5	Nevada 1
Connecticut Alabama	5	Vermont 1
Alabama	4	Rhode Island 1
Georgia	4	New Hampshire
Michigan	4	Maryland 1
Nebraska .	4.	Delaware 1
UKIADOMA	4	District of Columbia 1
Colorado	4	Hawaii 1
Oregon	4	

The defendant American also sells and ships ophthalmic goods to wholesalers located throughout the United States.

20. The defendant American, through its wholesaling branches, is one of the two largest wholesalers of ophthalmic goods in the United States. The branches of the defendant American operate as wholesalers of ophthalmic goods manufactured by the defendant American, as well as for some items manufactured by companies other than the defendant American, and which are shipped in interstate trade and commerce to such branches of the defendant American.

21. A large portion of the business done by the branches of the defendant American consists in making Rx or prescription sales of ophthalmic goods to optometrists. A much smaller volume of prescription sales is made to occulists.

22. Most optometrists do their own dispensing [fol. 209] of glasses for their patients, usually charge no separate fees for making ophthalmic refractions, and therefore make their profits from the sale of the spectacles or parts thereof to their patients. It is not economically feasible for most optometrists or oculists to maintain a large stock of lenses, frames, mountings, and other parts for spectacles, and maintain the machinery and equipment needed for grinding, polishing, edging, beveling, drilling, and mounting lenses. If they do their own dispensing of glasses for their patients, · they therefore turn to wholesalers, such as the branches of the defendant American, to have their prescriptions filled, whether such prescriptions involve replacing a single broken lens in a frame or making up a complete pair of spectacles.

23. Many Rx or prescription sales are made by branches of defendant American to optometrists or occlists located in States other than the one in which the branch making the Rx sale is located. Much of this interstate business is done by mail, with the optometrist or occlist mailing the prescription for his patient to the branch of the defendant American and American their mailing the filled prescription back to the customer, who then dispenses it to his patient.

24. The defendant American issues uniform Rx or prescription price lists to be followed by its branches when selling the products manufactured by American as well as those purchased from other manufacturers and shipped in interstate trade and commerce to the branches of the defendant American. The branches of the defendant American use and follow these price lists in making Px or prescription sales and in making charges for sales in which Rx or prescription prices are involved.

25. Oculists charge their patients a fee for the professional service involved in making ophthalmic refractions and prescribing lenses for the correction of visual defects. Some oculists, principally those in smaller towns and communities, especially where no wholesalers operate, do their

[fol. 210] own dispensing of glasses for their patients. Oculists who follow this procedure have their prescriptions filled by a wholesaler who charges the oculist the Rx or

prescription price.

26. Most oculists, however, particularly those in the larger communities where wholesalers are located, do little, if any, dispensing of glasses. They make ophthalmic refractions, prescribe lenses, and charge their patients a fee for such services. The patients then go to a wholesaler or to a retail optician to have the prescription filled and

dispensed.

27. The defendant American, through many of its branches, engages in wholesale dispensing for the patients of those oculists who do little, if any, of their own dispensions ing. In doing wholesale dispensing, the branches of the defendant American fill prescriptions for lenses, fit and adjust spectacles to the patient's face, and collect from the patient a consumer price for the prescribed spectacles or parts thereof. This consumer price is usually more than double the amount of the Rx or prescription price. The defendant American then rebates to or "credits" the doctor who wrote the prescription with part of the purchase price paid by the patient, this rebate usually amounting to approximately one-kalf the price collected from the patient.

28. In many cases the defendant American, instead of delivering spectacles or parts thereof to the patient in person, mails them to the patient and collects the consumer price from the patient on a C. O. D. basis. Frequently such C. O. D. collections are made from patients located in States other than the State in which the branch of the

defendant American mailing the package is located.

29. Checks for rebates or "credits" are mailed from zone or regional offices of the defendant American to defendant doctors located in States other than the States in which such zone or regional offices are located. Thus, the Chicago zone covers branches in 8 States; the Atlanta zone, branches im 6 States; the Memphis zone, branches in 2 States; the Dallas zone, branches in 1 State; the Kansas City zone, branches in 10 States; the San Francisco zone, branches in 7 States and the Territory of Hawaii; the Boston zone, [fol. 211] branches in 6 States; and the New York zone, branches in 8 States and the District of Columbia.

30. The doctor receiving the rebate or "credit" has already charged a fee to the patient for the professional service rendered in connection with the ophthalmic examination. The defendant American, in making the rebate to the doctor, retains out of the consumer price collected from the patient only the Rx or prescription price plus a fee (known as a fitting fee) for the services incident to handling the dispensing.

OFFENSE CHARGED

31. Since in or about the year 1938, and continuing to and including the date of the filing of this complaint, the defendants, well knowing the facts herein alleged, have been engaged in a continuing and unlawful combination and conspiracy to fix the consumer price of spectacles and parts thereof sold to patients of defendant doctors, which combination and conspiracy has been and is now in restraint of interstate trade and commerce in such spectacles and parts thereof in violation of Section 1 of the Act of Congress of July 2, 1890, entitled "An Act to protect trade and commerce against unlawful restraints and monopolies," as amended (15 U. S. C. 1), commonly known as the Sherman Act.

32. The aforesaid combination and conspiracy has consisted of a continuing agreement, understanding, and concert of action among the defendants, the substantial terms

of which have been:

(a) That the defendant American through its dispensing branches, sells spectacles and parts thereof on prescription directly to the patients of defendant doctors and collects a consumer price therefor from such patients which shall be the sum of the Rx or prescription price of the spectacles or parts thereof plus a fitting fee plus a substantial amount for a rebate or "credit" to the defendant doctor who prescribed for the patient;

[fol. 212] (b) That the total consumer price to be charged patients of defendant doctors by a dispensing branch of defendant American shall be at least as high as the local prevailing consumer prices charged by

optometrists and retail opticians for spectacles or parts

thereof of equivalent quality:

(c) That the defendant American rebate to or "explit" defendant doctors with the difference between the Rx or prescription price plus fitting fees, and the aforesaid prices collected from such patients by defendant American, and that defendant doctors accept such rebates or "credits," which are customarily approximately one-half of the consumer price collected from the patient;

(d) That the defendant American boycott and refuse to sell spectacles and parts thereof to patients of doctors who turn over rebates to their patients, or who insist that consumer charges made to their patients by defendant affiliates be reduced by the amount of the rebate which would otherwise be paid to the doctor;

- (e) That the defendants refrain from disclosing to patients of defendant doctors the Rx or prescription prices of spectacles or parts thereof, the fact that the prices charged to said patients by the defendant American includes an amount which is rebated to said defendant doctors, or the amount of such rebate.
- 33. The defandants will continue the offense herein charged unless the relief hereinafter prayed for is granted.

34. The aforesaid combination and conspiracy has been

effectuated by the following means and methods:

35. During the period covered by this complaint, the defendant American has made stock and Rx or prescription sales to optometrists in a volume far exceeding the volume of sales made to patients of defendant doctors, and has also made considerable stock cales to retail opticians.

36. Defendant American has sought to maintain the good will of optometrists and retail opticians who are its custo[fol. 213] mers by entering into agreements with defendant doctors to (a) maintain the consumer price of spectacles and parts thereof sold by defendant American to patients of defendant doctors, at levels at least as high as the prevailing local level of consumer prices charged by optometrists and retail opticians for spectacles and parts thereof of equivalent quality; and (b) conceal from consumer purchasers the fact that consumer prices for spectacles and

parts thereof are fixed at levels high enough to enable defendant American, as vendor, to give defendant doctors rebates of approximately one-half the consumer price paid

by their patients.

37. The defendant American, during the time covered by this complaint, has entered into agreements and understandings with the defendant doctors under which the defendant American has agreed through its dispensing branches (1) to fill prescriptions for lenses brought in by patients of the defendant doctors; (2) sell such patients spectacles and parts thereof under such prescriptions; (3) establish, for each dispensing branch of defendant American, consumer prices which would be substantially uniform ofor the patients of all defendant doctors served by such branch, be at least as high as the prevailing local level of consumer price charged by optometrists and retail opticians for spectacles and parts thereof of equivalent quality, and be sufficiently high to include a substantial rebate or "credit" to the defendant doctor who prescribed for the patient, which rebate would be approximately one-half of the consumer price charged to patient; (4) refuse to charge patients of any doctor a consumer price which does not include a substantial sum for rebate to the doctor in addition to the Rx or prescription price plus a fitting fee; (5) collect said consumer prices from patients of the defendant doctors for spectacles and parts thereof sold to such patients; (6) rebute to or "credit" the prescribing doctors with the amount so collected from their patients in excess of the Rx or prescription price plus a fitting fee; (7) keep secret from the patient the Rx or prescription [fol. 214] price of the spectacles or parts thereof purchased by the patient under prescription, the fact that the prices charged such patient include an amount which is rebated to said defendant doctors, and the amount of such rebate.

38. The defendant doctors, during the time covered by this complaint, have entered into agreements and understandings with the defendant American under which the defendant doctors have agreed (1) to refer patients to dispensing branches of defendant American to have their prescriptions filled or to recommend the defendant American to their patients for such purpose; (2) accept from the defendant American a repate or "credit" of the excess

above the Rx or prescription price plus fitting fee collected by the defendant American from patients of prescribing defendant doctors; (3) refrain from turning such rebates over to their patients; and (4) refrain from disclosing to their patients the Rx or prescription price of spectacles or parts thereof purchased from the defendant American.

39. The defendant American, pursuant to the foregoing agreements and understandings, has (1) sold spectacles and parts thereof on prescription to the patients of the defendant doctors; (2) collected from such patients consumer prices for spectacles or parts thereof approximately one hundred per cent higher than the Rx or prescription price of such ophthalmic goods, including a fitting fee; (3) rebated to or "credited" the prescribing defendant doctors with the amount collected from their patients in excess of the Rx or prescription prices, plus fitting fees; (4) refused to sell spectacles or parts thereof to the patients of doctors who pay over to their patients the amount of rebate received by the doctor on account of the sale of American of spectacles and parts thereof or who insist that consumer charges made to their patients by defendant affiliates be reduced by approximately the amount of the rebate which would otherwise be paid to the doctors; (5) refused to disclose to patients the Rx or prescription price of the spectacles and parts thereof sold to such patients, the fact that the prices charged such patients include an amount which is rebated to said defendant doctors, or the amount of such rebate. [fol. 215] 40. The defendant doctors, pursuant to the foregoing agreements and understandings; have accepted the rebates tendered them by the defendant American of part of the price paid by patients of such doctors for spectacles and parts thereof, which rebates have amounted on the average to approximately one-half of the consumer price collected from the patients by the defendant American, refrained from disclosing to their patients the Rx or prescription price of the spectacles or parts thereof purchased by such patients from defendant American, or the fact that a

amount of rebates received from the defendant American 41. The defendant American supplies each defendant doctor with a detailed statement concerning each sale made

rebate was paid to such doctor by the defendant American, and have refrained from paying over to their patients the

the name of the patient, a description of the ophthalmic goods sold to such patients, the Rx or prescription price of such goods, the fitting fee, the consumer price collected from the patient, and the amount of rebate or "credit" due the defendant doctor on account of such sale made by the defendant American. Periodically the defendant American settles its accounts with the defendant doctors by sending them checks for accrued rebates or by crediting such accrued rebates against the purchase of equipment or stock by the defendant doctors. Each of the defendant doctors has accepted all rebates or "credits" made and has known that other defendant doctors were also participating in the foregoing agreements and understandings with the defendant American.

VI

Effect of Such Combination and Conspiracy

42. The aforesaid combination and conspiracy, and the agreements entered into, and the acts done in furtherance thereof have had the following effects:

(a) Arbitrary and inflated consumer prices for spectacles and parts thereof have been fixed and t maintained:

[fol. 216] (b) Patients of defendant doctors have been forced to pay for spectacles or parts thereof consumer prices which have been inflated by the amount of the rebates or "credits" given by the defendant

American to the defendant doctors;

(c) Rebates or "credits" have been paid to defendant doctors which amount on the average to approximately one-half the consumer price paid by patients of defendant doctors to defendant American for spectacles or parts thereof. The amount of such rebates or "credits" in representative actual transactions is shown in Schedule A attached hereto and made a part hereof;

(d) Defendant doctors have acquired a pecuniary interest in maintaining the price of spectacles and parts thereof at excessive and artificial levels, notwithstanding that defendant doctors have already received

professional fees from their patients for services rendered. The amount of such pecuniary interest on the part of the defendant doctors is illustrated by Schedule B attached hereto and made a part hereof, setting forth the amount of the rebates paid during 1944 and 1945 by the defendant American to the individual defendant doctors named herein;

(e) Interstate trade and commerce in spectacles and parts thereof has been unreasonably restrained in violation of Section 1 of the Sherman Antitrust Act.

Prayer

Wherefore plaintiff prays:

1. That the aforesaid combination and conspiracy in restraint of interstate trade and commerce in spectacles and parts thereof be adjudged and decreed to be unlawful, and that the agreements, understandings, and practices alleged in this complaint be adjudged and decreed to be in violation of the Sherman Act.

2. That the defendant American and its officers, employees, representatives, and agents be enjoined perpetually [fol, 217] from directly or indirectly making any rebates or granting any "credits" to defendant doctors, through agents or representatives, of any part of the purchase price paid by patients of such doctors, to the defendant American for spectacles or parts thereof purchased on prescription, whether such rebate or "credit" is given directly as by cash or check, or is given indirectly by applying the amount of the rebate or "credit" against the purchase by the oculist of stock or equipment, or by payment to a charity or other person or organization designated by the doctor, or by any other method.

3. That defendant doctors be enjoined perpenally from participation in any plan or program, with any wholesaler whereby said doctors receive, directly or indirectly, any part of the purchase price of spectacles or parts sold by said wholesaler to patients of said doctors.

4. That the defendant American, for a period of three years from the entry of the decree herein, be enjoined, as to its branches doing dispensing at the time this complaint

was filed, from refusing to sell spectacles or parts thereof on prescription to the patients of any doctors, at the defendant American's Rx or prescription prices, plus the fitting fee prevailing in the dispensing branch at the time this complaint was filed.

5. That the defendant American be perpetually enjoined from refusing to make stock and Rx or prescription sales of spectacles and parts thereof to doctors who, in doing their own dispensing, sell spectacles or parts thereof to their patients at less than the local prevailing level of con-

sumer prices charged by optometrists. "

6. That pursuant to Section 5 of the Sherman Act, an order be made and entered herein, requiring such of the defendants as are not within this District to be brought before the Court in this proceeding as parties defendant, and directing the Marshals of the Districts in which they severally reside to serve summons upon them.

[fol. 218] . 7. That the plaintiff have such further, general and different relief as the nature of the case may require

and the Court may deem proper in the premises.

George B. Haddock, Melville C. Williams, Willis L. Hotchkiss, Special Assistants to the Attorney General.

Tom C. Clark, Attorney General, Wendell Berge, Assistant Attorney General. Holmes Baldridge, Special Assistant to the Attorney General. J. Albert Woll, United States Attorney. Suite 820, 208 South LaSalle Street, Chicago 4, Illinois.

Schedule A

Representative transactions involving the sale of spectacles or parts thereof by a dispensing branch of defendant American to patients of defendant doctors, showing:

- (a) Rebate or "credit" paid to a defendant doctor on account of the transaction;
- (b) Consumer price collected from the patient by the dispensing branch of defendant American;
- (c) Rx or prescription price of the spectacles or parts thereof retained by the defendant American;

together with identification number of the transaction, the date the sale was made, and the location of the branch of the defendant American making the sale.

fol. 219] Defendant American Branch Rx number	Date of sale	Consumer price collected from patients	Rx or prescription price (including fitting fee)	Rebate or "credit", paid to a defendant doctor
Transactions Fro	om Chicago I	Branches of D	efendant Amer	ionn a
38816	6/30/44	\$14.00		* \$11.50
38687	6/29/44	12.00	4.65	-7.35
38988	7/. 5/44	7.25		4.40 3.20
38502		9.25 25.00	6.05 10.80	14.20
37660		10.00	3.80	6.20
38684	6/28/44	12.25	6.45	5.80
38567	6/18/44	13.50	7.55	5.95
38676	6/29/44	13.00	6.10	6.90
38688	6/29/44	13.00	6.20	-6.80
38983		7.00	4.70	2.30 2.25
38746		3.50 2.75	1.25 1.30	1.45
38817	6/30/44	8 3.64	1.52	2.12
38878 38887		3.00	2.75	. 25
88954		16.00	6.85	9.15
39003		12.25	4.85	7.40
9064	7/ 5/44	1.00	.50	.50
9071	7/ 5/44	4.50	2.15	2.35
9076	71 5/44	3.50	2.35	1.15
9109		13.00	5.95	7.05
9130	- 10/44	8.00 3.25	3.45 1.15	4.55 2.10
9179		5.00	3.00	2.00
89180		2.50	1.65	. 85
39372		2.00	1.25	75
31363		5.00	1.73	3.27
31424	7/ 1/44	18.00	8.22	9.78
31470	7/8/44	g: 24.00	12.00	12.00
31580	7/18/44	10.00	4.95	5.05
37536	6/17/44	7.50	3.80	3.70 12.65
38006	6/24/44	25.00 25.00	12.35 10.65	14.35
88061		11.00	4.60	6.40
38144	A 100 4 1 4 4	10.00	4.10	5,90
8170		15.00	9.05	5.95
38179	A 15 # 144	17.00	7.65	9.35
38274	6/26/44	15.00	7.30	7.70
59342	2/ 1/45	8.00	2.40	5.60
59349	• 2/. 1/45	15.00	5.30	\$9.70
59864	2/ 1/45	15.00	10.50	4.50 8.25
59371	2/ 1/45	16.50	8.25	8.25
59372		3.Q0	1.30	1.70
59381 59382	2/ 1/45	4.00	1.55	2.45
59460	2/ 2/45	12.00	6.40	5.60
59494	2/ 2/45	13.00	5.95	7.05
59558	2/ 5/44	2 . 7.25	0 . 2.85	4.40
59559	2/ 5/45	B 10.00	5.45	4.55

4						
		2/ 5/45	16.00	7.55	8.45	
	59565		A 6.50	2.85	3.65	
	59570	2/ 5/45		5.70	5.80	ě
	5957P	2/5/45	11.50	0.00	8.75	
	59647	2/ 5/45	15.00	6.25	THE RESERVE THE PARTY OF THE PA	d
400	59648	2/ 5/45	18.00	8.80°	9.20	ġ
	59694	2/ 6/45	25.00	12.00	, 13.00	
933	09004					
	[fol. 220]			10 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1		
	[101. 220]		Consumer	. Rx or	Rebate or	g
		Date	price	prescription	"credit"	
	Defendant .	STATE OF THE PERSON NAMED IN COLUMN TWO IS NOT THE OWNER.	A COUNTY TO SEE STATE OF THE PARTY OF THE PA	#price	paid to a	
	American Branch	of	collected.		defendant	
Br.	Rx number &.	sale	from	(including		
SIF.	The same of the same of the same of		o patients	fitting fee)	doctor	3.
			T	-Cd A	minan.	
	Transactions Fron	n Dallas, Tex.	, Branch of L	erendant Ame		
	1028. 9 - 464	2/ 1/45	\$26.00	\$13.25	\$12.75	
	679		18.00	8.25	9.75	
	400	1/29/45	15.00	7.40	7.60	
120	678		17.00	8.25 .	8.75	
	1729	2/ 1/45		7.85	8.15	4
	1929 / 6	2/ 1/45	16.00	3.20	2.80	
	1697	2/ 2/45	.6.00			
	2023	2/ 2/45	21.00	10.75	10.25	
	2148	2/ 2/45	19.00	11.85	7. 15	
學院	2286	2/ 3/45	18.00	8.55	9.45	
10		A STATE OF THE PARTY OF THE PAR	8.00	4.20	3.80	
1	2337	2/ 3/45	8.00	D RE	8 45	
	2337 2355	2/ 3/45 2/ 3/45	15.00	8.55	6.45	
	2337	2/ 3/45 2/ 3/45	TO DESCRIBE THE TOTAL PROPERTY OF THE PARTY	D RE	8 45	
	2337 2355	2/ 3/45 2/ 3/45	15.00 14.00	8.55 a 6.90	6.45 7.10	The state of the s
	2337 2355	2/ 3/45 2/ 3/45	15.00	8.55 a 6.90 Rx or	6.45 7.10 Rebate or	
	2337	2/ 3/45 2/ 3/45 2/ 5/45	15.00 14.00	8.55 6.90 Rx or prescription	6.45 7.10 Rebate or "credit"	
	2337	2/ 3/45 2/ 3/45 2/ 5/45 Date	15.00 14.00 Consumer price	8.55 6.90 Rx or prescription	6.45 7.10 Rebate or "credit" paid to a	
	2337	2/ 3/45 2/ 3/45 2/ 5/45 Date of	15.00 14.00 Consumer price collected	Rx or prescription price	6.45 7.10 Rebate or "credit" paid to a	
	2337	2/ 3/45 2/ 3/45 2/ 5/45 Date	15.00 14.00 Consumer price collected from	Rx or prescription price (including	6.45 7.10 Rebate or "credit" paid to a defendant	
	2337 2355 2672 Defendant American Branch Rx number	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale	15.00 14.00 Consumer price collected from patients	Rx or prescription price (including fitting fee)	Rebate or "credit" paid to a defendate doctor	
	2337 2355 2672 Defendant American Branch Rx number	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale	15.00 14.00 Consumer price collected from patients	Rx or prescription price (including fitting fee)	Rebate or "credit" paid to a defendate doctor	
	2337. 2355. 2672. Defendant American Branch Rx number Transactions From Oklal	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale	15.00 14.00 Consumer price collected from patients Oklahoma Bra	Rx or prescription price (including fitting fee)	6.45 7.10 Rebate or "credit" paid to a defendate doctor	
	2337 2355 2672 Defendant American Branch Rx number	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale homa City, O	15.00 14.00 Consumer price collected from patients Oklahoma Bra	Rx or prescription price (including fitting fee) nch of Defend	Rebate or "credit" paid to a defendat doctor ant American	
	2337. 2355. 2672. Defendant American Branch Rx number Transactions From Oklal 38016.	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale homa City, O	Consumer price collected from patients oklahoma Bra	Rx or prescription price (including fitting fee) nch of Defend	Rebate or "credit" paid to a defendate doctor ant American \$13.70	
	2337. 2355. 2672. Defendant American Branch Rx number Transactions From Oklal 38016. 38000.	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale homa City, O 2/ 2/45 2/ 2/46 2/ 2/46	Consumer price collected from patients oklairoma Bra 10.00 17.00	Rx or prescription price (including fitting fee) nch of Defend	Rebate or "credit" paid to a defendat doctor ant American \$13.70 , 6.30 9.75	
	2337 2355 2672 Defendant American Branch Rx number Transactions From Oklal 38016 38000 37812	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale homa City, O 2/ 2/45 2/ 2/46 2/ 2/46	Consumer price collected from patients oklahoma Bra	Rx or prescription price (including fitting fee) nch of Defend	Rebate or "credit" paid to a defendat doctor ant American \$13.70 \$6.30 9.75 1.95	
	2337 2355 2672 Defendant American Branch Rx number Transactions From Oklal 38016 38000 37812 37853	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale homa City, O 2/ 2/45 2/ 2/46 2/ 2/46 2/ 2/45	Consumer price collected from patients oklairoma Bra 10.00 17.00	Rx or prescription price (including fitting fee) nch of Defend	6.45 7.10 Rebate or "credit" paid to a defendat doctor ant American \$13.70 6.30 9.75 1.95 9.80	
	2337 2355 2672 Defendant American Branch Rx number Transactions From Oklal 38016 38000 37812 37853 37829	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale homa City, O 2/ 2/45 2/ 2/46 2/ 2/46 2/ 2/45 2/ 2/45 2/ 2/45	15.00 14.00 Consumer price collected from patients Oklatioma Bra \$26.00 10.00 17.00 3.50 17.00	Rx or prescription price (including fitting fee) nch of Defend \$12.30 3.70 7.25 1.55	Rebate or "credit" paid to a defendat doctor ant American \$13.70 \$6.30 9.75 1.95	
	2337. 2355. 2672. Defendant American Branch Rx number Transactions From Oklal 38016. 38000. 37812. 37853. 37829. 37808.	2/ 3/45 2/ 3/45 2/ 5/45 Date of sale homa City, O 2/ 2/45 2/ 2/46 2/ 2/46 2/ 2/45 2/ 2/45 2/ 2/45 2/ 2/45 2/ 2/45	15.00 14.00 Consumer price collected from patients Oklatioma Bra \$26.00 10.00 17.00 3.50 17.00 24.00	8.55 6.90 Rx or prescription price (including fitting fee) nch of Defend \$12.30 3.70 7.25 1.55 7.20 11.00	6.45 7.10 Rebate or "credit" paid to a defendate doctor ant American \$13.70 6.30 9.75 1.95 9.80 13.00	
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SCHEDULE B

Rebates or "Credits" Paid by Defendant American During 1944 and 1945 to Defendant Doctors Named in this Complaint

	Name of defendant doctor receiving rebates	Address	Rebates paid by defendant Amer- ican [rebates' made in 1944 designated (*); those not so designated wers made in 1945]
	Nesh Fox	Chicago	\$4,012.75*
	C H Manda	Chia	1,656.85*
	A. J. Blickenstaff	. Peona	9,319.90
	Steve A. O'Brien	Iowa Mason City	21,796.86
	Loran M. Martin		
	Herman C. Kluever?? Chas. H. Coughlin	. Fort Dodge	42,107 03
7		Kansas	
	Frank C. Boggs	. Topeka	15,898.06
	W. O. Quiring	. Wichita	11,516.27 15,672.13
		Louisiana	The Name of Street, and the St
	J.,D. Woolworth	. Shreveport	13,525.45
	N. T. Simmonds	. Alexandria	14,634.93
		Missouri	
	E. J. Curran. Joseph S. Summers.	. Kansas City	16,436.71 .13,044.15
		Oklahoma	.10,011.10
	Wm. Orlando Smith	Oklahoma Tulsa	13,659.33
		Texas	Hally Land
	John J. Crume	Access on the second se	20,523.75
	Frederic J. Crumley Bernard B. Friedman	Corpus Christi	12,777.56
	Fred R, Landon	Wichita Falls	14,751.42
		Wisconsin	
	H. J. Heeb.		12,806.32*
	Reinhold O. Ebert	. Oshkosh	9,704.27*
N.	Erwin W. Newman	. Cheyenne	13,832.64
		Charge and Control of the Control of	10,002.04
	Total		\$277,676.38
	THE RESERVE OF THE PERSON OF T	Section belongs to the first that the second section is the second section of the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the second section in the second section in the second section is the section in the section is the second section in the section is the section	

[fol. 222] PROCEEDINGS IN THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 6204

THOMAS B. LILLY and HELDN W. LILLY, Petitioners,

COMMISSIONER OF INTERNAL REVENUE, Respondent

On Petition to Review the Decisions of The Tax Court of the United States

December 7, 1950, the transcript of record is filed and

the cause docketed.

Same day, certified copy of order extending to December 15, 1950, the time for the preparation, transmission and delivery of the record on review is filed.

December 12, 1950, the appearance of Theron Lamar Caudle, Assistant Attorney General, and Ellis N. Slack, Special Assistant to the Attorney General, is entered for

the respondent

December 23, 1950, the appearance of Richard E. Thigpen is entered for the petitioners.

[fol. 223] December 26, 1950, the appearance of Charles Oliphant, Chief Counsel, and John M. Morawski, Special Attorney, Bureau of Internal Revenue, is entered for the respondent.

January 5, 1951, motion of Association of Independent Optical Wholesalers, consented to by counsel for the respective parties, for leave to file brief as amicus curiae, is

filed.

ORDER PERMITTING ASSOCIATION OF INDEPENDENT OPTICAL WHOLESALERS TO FILE BRIEF AS AMICUS CURIAE—Filed and Entered January 5, 1951

(Style of Court and Title Omitted)

Upon the motion of the Association of Independent Optical Wholesalers, by their counsel, Lehrich and Lehrich, for leave to file brief as amicus curiae in the above entitled case, and it appearing that counsel for the respective parties have consented thereto.

Leave is hereby granted the said Association of Independent Optical Wholesalers to file a brief as amicus curiae in the above entitled case, provided twenty-five (25) printed copies of same are filed and copies served upon counsel in the case at least twenty-three (23) days before the beginning of the March Term, 1951.

January 5th, 1951.

John J. Parker, Chief Judge, Fourth Circuit.

[fol. 224] February 8, 1951, brief of the Association of Independent Optical Wholesalers as amicus curiae is filed.

February 15, 1951, brief for petitioners and appendix to

brief are filed.

February 24, 1951, the original exhibits are certified up. March 5, 1951, stipulation as to the time for the filing of respondent's brief is filed.

March 7, 1951, brief and appendices of respondent are

filed.

Same day, the appearance of Lee A. Jackson and I. Henry Kutz, Special Assistants to the Attorney General, is entered for the respondent.

MOTION OF PETITIONERS TO STRIKE APPENDIX A FROM RESPONDENT'S BRIEF-Filed March 9, 1951

(Style of Court and Title Omitted)

Comes now the petitioners, by their counsel, and moves the Court to have stricken from the Respondent's Brief, Appendix A thereto, because the content of said Appendix A forms no part of the record in this case, and the printing of said Appendix A is in violation of Section 10(4)(e) of the Rules of this Court, wherein it appears that

[fol. 225] 4. The brief of appellee or respondent shall contain:

(e) An Appendix containing such parts of the record as he desires the Court to read, and as have not been printed in the brief of appellant or petitioner.

> Respectfully submitted, Richard E. Thigpen, Arthur M. Jenkins, Counsel for Petitioners.

Charlotte, North Carolina, March 8, 1951.

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March 12, 1951, reply brief of the Association of Independent Optical Wholesalers as amicus curiae is filed.

Same day, memorandum in support of petitioners' motion to strike Appendix A from Respondent's Brief is filed.

ARGUMENT OF CAUSE

March 12, 1951 (March term, 1951), cause came on to be heard on the motion and the merits before Parker and Dobie, Circuit Judges, and Watkins, District Judge, and was argued by counsel and submitted.

[fol. 226] Opinion-Filed April 2, 1951

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 6204

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE, Respondent

On Petition to Review the Decisions of The Tax Court of the United States

Argued March 12, 1951. Decided April 2, 1951.

Before Parker and Dobie, Circuit Judges, and Watkins, District Judge

Richard E. Thigpen (Arthur M. Jenkins on brief) for Petitioner; and I. Henry Kutz, Special Assistant to the Attorney General, (Theron Lamar Caudle, Assistant Attorney General; Ellis N. Slack and Lee A. Jackson, Special Assistants to the Attorney General, on brief) for Respondent; and Lehrich & Lehrich on brief for The Association of Independent Optical Wholesalers as Amicus Curiae.

[fol. 227] Dobie, Circuit Judge:

This is an appeal from a decision of the Tax Court of the United States sustaining the disallowance by the Commissioner of Internal Revenue of certain alleged "trade discounts" claimed by Thomas B. Lilly and Helen W. Lilly

(hereinafter referred to as taxpayers), trading as the City Optical Company of Wilmington, North Carolina, totaling \$61,601.95 and \$60,021.65 for the years 1943 and 1944 respectively, and against Helen W. Lilly, trading as the Duke Optical Company, in the amounts of \$6,568.87 and \$4,798.35 for the years 1943 and 1944 respectively.

The facts are not disputed. Taxpayers, who are engaged in the business of grinding, fitting and selling eye glasses and spectacles, entered into oral contracts with various oculists whereby taxpayers agreed to pay the oculists one-third of the retail price of all eye glasses and spectacles purchased by patients sent to them by the oculists. The evidence shows that the oculists did not inform their patients of this rebate arrangement but such a disclosure was made only when it was specifically requested by individual patients.

The sole issue in this case is whether these rebates paid by taxpayers to the doctors were deductible under \$23(a) (1)(A) of the Internal Revenue Code, 26 U.S.C.A. \$23(a) (1)(A), as "ordinary and necessary" business expenses.

We feel that the answer to this must be in the negative. As the courts have frequently said, the allowance of a deduction is a matter of legislative grace and not a matter of right. Deputy v. duPont, 308 U.S. 488, 60 S. Ct. 373, 84 [fol. 228] L. Ed. 416; White v. United States, 305 U.S. 281, 59 S. Ct. 179, 83 L. Ed. 172; City Ice Delivery Co. v. United States, 4 Cir. 176 F. 2d. 347. Once, therefore, the Commissioner has made a determination against deductibility, the burden is upon the taxpayer to prove the Commissioner wrong. Welch v. Helvering, 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212.

The wording of the statute that in order to be deductible, an expense must be "ordinary and necessary" is sufficiently broad to require interpretation by the courts. As we said in City Ice Delivery Co. v. United States, 176 F. 2d. 347, 350: "These be rather strong adjectives which the courts have often been called upon to define and apply." Through this process of judicial interpretation has been evolved the rule that no deduction should be allowed as "ordinary and necessary" which violates sharply defined public policy. Commissioner v. Heininger, 320 U.S. 467, 64 S. Ct. 249, 88 L. Ed. 171; National Brass Works v. Commissioner, 9 Cir., 182 F. 2d. 526; Commissioner v. Longhorn Portland Cement Co., 5 Cir., 148 F. 2d. 276; Rugel v. Commissioner, 8 Cir., 127 F.

2d. 393. We must examine these kickbacks in the light of this rule.

This court is not at all impressed with the argument that such an inquiry amounts to judicial legislation, for we are only interpreting what Congress meant by the use of the words "ordinary and necessary." As Mr. Justice Black said in Commissioner v. Heininger, 320 U.S. at page 473:

"The Bureau of Int-rnal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in §23(a) in order that tax deduction consequences might not frustrate sharply defined na-[fol. 229] tional or state policies proscribing particular types of conduct."

In Winfield, Prbiic Policy In The English Common Law, 42 Harv. L. Rev. 76 (1928), the author states (p. 97):

"But the better view seems to be that the difficulty of discovering what public policy is at any given moment certainly does not absolve the bench from the duty of doing so. The judges are bound to take notice of it and of the changes which it undergoes, and it is immaterial that the question may be one of ethics rather than of law. The basis for their decision is 'the opinions of men of the world, as distinguished from opinions based on legal learning.' Of course it is not to be expected that men of the world are to be subpoenaed as expert witnesses in the trial of every action raising a question of public policy. It is the judges themselves assisted by the bar, who here represent the highest common factor of public sentiment and intelligence."

"The relationship of patient and physician is to the highest possible degree a fiduciary one, involving every element of trust and confidence" Stryker, Courts and Doctors, (1932) p. 9.

To such a relationship, one uberrimae fidei, the oft-quoted words of Chief Judge (afterwards Mr. Justice), Cardozo, in Meinhard v. Salmon, 249 N.Y. 458, 464, are peculiarly applicable:

"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden.

to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to [fol. 230] this there has developed a tradition that is unbending and inveterate."

Quite germane, too, is that statement in 6 Williston on Contracts, (Rev. Ed.), 4907:

"Clearly an agreement, for a secret consideration, to influence one with whom the promisor stands in a confidential relation is illegal. " or to influence one who may consult him in a confidential relation, " "."

See, also, Amer. Law Inst. 2 Restatement, Contracts, \$570. We certainly will not lend the force of any opinion of this court to sanction, as an "ordinary and necessary" expense of the optician's business, the making and carrying out of such unconscionable and reprehensible contracts for secret kickbacks to a doctor.

A doctor owes the duty of undivided loyalty to his patients, and a contract which violates this duty is unenforceable and opposed to public policy. One cannot at the same time serve two incompatible masters. Wolfe v. International Reinsurance Corp., 2 Cir., 73 F. 2d. 267; Reilly v. Beekman, 2 Cir., 24 F. 2d. 791; City of Findlay v. Pertz, 6 Cir., 66 Fed. 427. Reilly v. Beekman, supra, was a suit for breach of contract. Beekman had agreed to pay Reilly one-half of all legal fees he collected from clients referred to him by Reilly. In holding the contract unenforceable, the court said (24 F. 2d. at page 794):

"It cannot be disputed that, if Reilly was in a fiduciary relation to Mrs. Trenkman when he recommended Beekman to her as her attorney, he could not agree to profit from the business arising out of the introduction without her knowledge and consent. This is because Mrs. Trenkman was entitled to his disinterested advice as to the attorney to be recommended to her. That [fol. 231] advice was not likely to be disinterested, if affected by the consideration of whether or not he could make a profit out of the recommendation of a particular person."

The evil we find in these kickbacks is the receipt by the physician of secret profits through dealings with his patients. Surely, the doctor is assuming an utterly inconsistent position when he recommends an optician without disclosing that he is being paid for the recommendation. This corrupt practice obviously involves, or tends to promote, terious evils: (1) the prescription by the doctor of glasses where not actually necessary; (2) more expensive lenses than really needed; (3) recommendation of an inferior optician; (4) artificial increase in the cost of glasses by the inclusion of the phy-ician'- commission, for which the physician affords no value to the patient. The bait of the secret consideration, which taxpayers offered to the doctor, hopelessly divides the trust interest of the doctor.

At least two states have thought this practice so insidious as to pass legislation forbidding it. See California Business and Professional Code §650 (Deering, 1949, Supp.); Revised Statutes of Washington, Anno., §10185-14 (Remington 1949 Supp.). We hold, since these kickbacks corrupt the fiduciary relationship between physicians and patient and result in a violation of the duty of loyalty, they are opposed to public policy and, therefore, are not deductible as "ordinary and necessary" business expenses by these taxpayers.

That these deductions are opposed to public policy is borne out by the standards set by the medical profession itself. We find among the Principles of Medical Ethics of the American Medical Association, Chapter III, Art. 1, \$5, (1943), the following:

[fol. 232] "It is unprofessional to accept rebates on prescriptions or appliances, or perquisites from attendants who aid in the care of patients."

And in Chapter III, Art. VI, §4:

"When a patient is referred by one physician to another for consultation or for treatment, whether the physician in charge accompanies the patient or not, it is unethical to give or to receive a commission by whatever term it may be called or under any guise or pretext whatsoever."

The record and the opinion of the Tax Court also show that these kickbacks had been condemned by the Medical

D

Society of North Carolina—the State in which these taxpayers were chiefly engaged in business.

We are not impressed by the argument of counsel for taxpayers that this custom of secret kickbacks from opticians to doctors is so common and so widespread that such payment must be deductible because the Commissioner of Internal Revenue has issued no regulation specifying that such payments are not deductible. No decision precisely in point has been cited to us. Nor does the record disclose either that the Commissioner had been definitely apprised of this practice or that he had ever made any tuling on it. Certainly if other opticians, as did taxpayers here, camouflaged these payments as "trade discounts", there was little to put the Commissioner on notice that the deductions claimed were the secret kickbacks from optician to doctor.

Had taxpayers desired a specific ruling on this question by the Commissioner, this could easily have been obtained by a full and frank disclosure of the exact nature of these so-called "trade discounts." The Commissioner can hardly [fol. 233] be expected, by specific regulations, to cover every form of commercial practice.

The decision of the Tax Court of the United States is affirmed.

Affirmed.

[fol. 234] JUDGMENT-Filed and Entere April 2, 1951

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 6204

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE, Respondent

On petition to review the decisions of The Tax Court of the United States.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the decisions of the said The

Tax Court of the United States, in this cause, be, and the same are hereby, affirmed.

April 2, 1951.

Armistead M. Dobie, U. S. Circuit Judge.

April 24, 1951, petition of petitioners for a stay of mandate is filed.

[fol. 235] ORDER STAYING MANDATE-Filed April 26, 1951

(Style of Court and Title Onlitted)

Upon the petition of the petitioners, by their counsel, Richard E. Thigpen, Esq., and for good cause shown,

It is ordered that the mandate of this Court in the above entitled case be, and the same is hereby, stayed pending the application of the said Petitioners in the Supreme Court of the United States for a writ of certiorari to this Court, unless otherwise ordered by this or the said Supreme Court, provided the application for a writ of certiorari is filed in the said Supreme Court within 30 days from this date.

April 25, 1951.

John J. Parker, Chief Judge, Fourth Circuit.

May 26, 1951, motion for further stay of mandate is filed.

ORDER FURTHER STAYING MANDATE Filed May 31, 1951

(Style of Court and Title Omitted)

Upon the motion of the petitioners, by their counsel, Rich-[fol. 236] ard E. Thigpen, Esq., and for good cause shown,

It is ordered that the mandate of this Court in the above entitled case be, and the same is hereby, further stayed pending the application of the said petitioners in the Supreme Court of the United States for a writ of certiorari to this Court, unless otherwise ordered by this or the said Supreme Court, provided the application for a writ of certiorari is filed in the said Supreme Court within 30 days from this date.

May 30th, 1951.

John J. Parker, Chief Judge, Fourth Circuit.

[fol. 237]

STIPULATION

IN THE SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1950

No. -

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

Subject to this court's approval, it is hereby stipulated and agreed, by and between counsel for the respective parties hereto, that for the purpose of the petition for a writ of certiorari, the printed record may consist of the following:

1. Appendix to brief of petitioners in the United States Court of Appeals for the Fourth Circuit.

2. Appendix B to brief of respondent in the United States Court of Appeals for the Fourth Circuit.

3. The proceedings had before the United States Court of Appeals for the Fourth Circuit.

It is further stipulated and agreed that petitioners will cause the Clerk of the United States Court of Appeals for the Fourth Circuit to file with the Clerk of the Supreme [fol. 238] Court the complete certified record on review in the Court of Appeals for the Fourth Circuit; and that, in the event that the petition for writ of certiorari is granted, the printed record shall consist of the proceedings in the court below and such portions of the complete record on review in that court as the parties may designate.

It is further stipulated and agreed that either of the parties hereto may refer in his brief to the record filed in the Supreme Court of the United States.

June 13, 1951.

Randolph E. Paul, Louis Eisenstein, Counsel for Petitioners; Philip B. Perlman, Solicitor General, Counsel for Respondent. [fol. 239]

CLERK'S CERTIFICATE

UNITED STATES OF AMERICA, Fourth Circuit, ss:.

I, Claude M. Dean, Clerk of the United States Court of Appeals for the Fourth Circuit, do certify that the foregoing is a true copy of the appendix to brief of petitioners, Appendix B to brief of respondent and the proceedings in the said Court of Appeals in the therein entitled cause, as the same remain upon the records and files of the said Court of Appeals, and constitute and is a true transcript of the record and proceedings in the said Court of Appeals in said cause, made up in accordance with the stipulation of counsel for the respective parties, for use in the Supreme Court of the United States on application for a writ of certiforari.

In testimony whereof, I hereto set my hand and affix the seal of the said United States Court of Appeals for the Fourth Circuit, at Asheville, North Carolina, this 20th day of June, A. D., 1951.

Claude M. Dean, Clerk of the United States Court of Appeals for the Fourth Circuit. (Seal.)

(5711)

[fol. 234] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1951

No. 158

[Title omitted]

ORDER ALLOWING CERTIORARI-Filed October 8, 1951

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fourth Circuit is granted.

The case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(8078)

No. 158

4. ...

Office Supreme Court, U. S. FILED

JUN 39 1051

CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

COMMISSIONER OF INTERNAL REVENUE, Respondent.

TITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

RANDOLDH E. PAUL, LOUIS EISENSTEIN,

Counsel for the Petitioners.

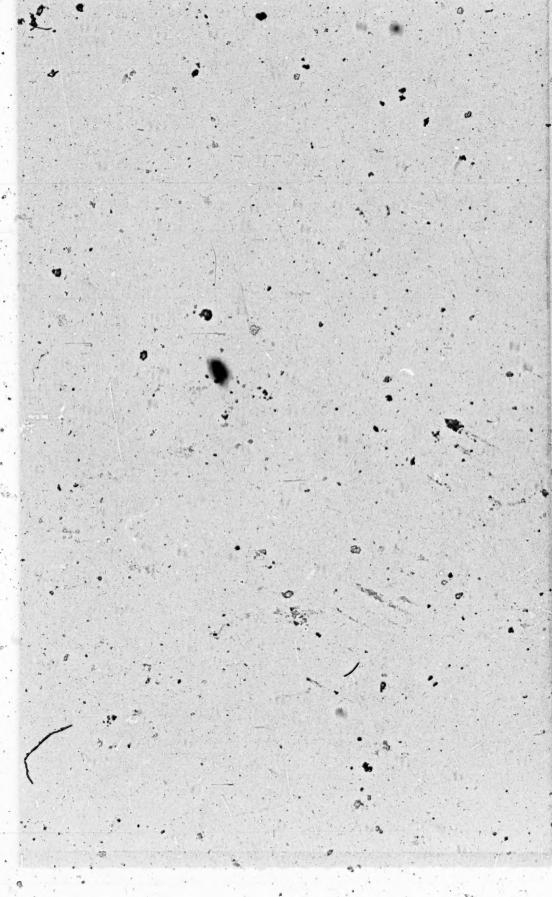


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IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

V.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioners, Thomas B. Lilly and Helen W. Lilly, pray that a writ of certicrari be issued to review the decision of the United States Court of Appeals for the Fourth Circuit in the above case.

OPINIONS BELOW.

The opinion of the Tax Court of the United States (App. 176-196), Judge Arundell dissenting (App. 196-199), is reported in 14 T. C. 1066. The opinion of the United States Court of Appeals for the Fourth Circuit (R. 224) is reported in 188 F. (2d) 269.

^{&#}x27;"Tr" designates references to portions of the transcript of the testimony printed in the Appendix to the petitioners' brief in the Court below. "App." designates other portions of the same Appendix. "R." refers to additional portions of the printed record.

JURISDICTION.

The judgment of the United States Court of Appeals was entered on April 2, 1951. (R. 224.) The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1), 62 Stat. 928.

QUESTIONS PRESENTED.

During the taxable years the petitioners were engaged in the optical business. Pursuant to agreements with various eye doctors, which reflected an established and widespread industry practice, the petitioners regularly credited and paid one-third of the price charged for glasses to the doctor who prescribed the glasses for the customer. The questions presented are:

- 1. Whether the amounts credited and paid to the doctors were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as ordinary and necessary expenses of doing business.
- 2. Whether the courts below erred in holding that these amounts were not deductible under Section 23(a)(1)(A) of the Internal Revenue Code because of public policy.

STATUTE INVOLVED.

The statute involved is Section 23(a)(1)(A) of the Internal Revenue Code.

"Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

- (a) Expenses-
 - (1) Trade or business expenses—

STATEMENT OF FACTS.

The petitioners are husband and wife, who in 1943 and 1944 were engaged in the optical business. As partners they owned and operated the City Optical Company, with offices in Wilmington, Fayetteville, and Greensboro, North Carolina, and in Richmond, Virginia. In addition, petitioner Helen W. Lilly owned and operated the Duke Optical Company in Fayetteville, North Carolina. (App. 163, 176-177.)

For many years before 1920 eye doctors or oculists customarily sold glasses to their patients. After examining the patient's eyes, the doctor would buy the necessary frame and lenses from a wholesale optician, and then resell the finished glasses to the patient. The doctor would keep the difference between the wholesale price paid to the optician and the larger retail price paid by the patient. Many doctors still do their own "dispensing," that is, they buy the lenses and frame and resell them to the patient. The physician's gain consists of a fee for services and the difference between the wholesale price and the retail price of the glasses. (Tr. 68, 155, 180, 184-185, 192, 220, 222, 234, 236, 326, 414-415, 491; App. 179.)

In 1922, when Mr. Lilly organized the City Optical Company, another practice was firmly established in the optical a industry. Instead of buying and reselling the glasses, many doctors referred their patients to designated opticians, who would directly furnish and fit the glasses, and charge the patients a retail price. Pursuant to agreement between the optician and the doctor, the former would remit a portion of the retail price to the latter. This arrangement did not increase the price which the patient would otherwise pay for the glasses. At the same time the doctor's gain was somewhat diminished because the optician included a fitting charge in his price. It was felt that this arrangement was superior to the other because the patient obtained better service when the glasses were fitted and adjusted. (Tr.

68, 69, 174, 192, 207, 215, 216, 222, 234, 241, 326, 376, 390, 422,

423, 491, 512-513; App. 176.)

The practice of rebates to doctors was widespread throughout the taxable years 1943 and 1944, as well as the intervening taxable years after 1922. In accordance with this trade practice the petitioners paid a number of doctors one-third of the price received on the sale of glasses to their patients.² The petitioners would not have been able to operate successfully if they had failed to abide by the established trade practice of rebates. Physicians were unwilling to surrender the available differential between the wholesale and retail prices unless they were assured of the customary rebate. (Tr. 68-69, 70, 154, 155, 174, 215, 216, 222, 234, 242, 326, 403, 404, 413-414, 421, 430, 490, 498; App. 176.)

The respondent determined deficiencies for 1943 and 1944 on the ground that the rebates were not deductible items. He therefore increased the petitioners' taxable income in

the following amounts for the following years:3

Year	City Optical . Company	Duke Optical Company
1942	\$57,063.45 61,601.95	\$6,568.87
1943 1944	60,021.65	4,798.35

In terms of the City Optical Company's taxable income as recomputed by the respondent, the disallowed rebates exceeded 56 per cent of the Company's taxable income for 1942, 61 per cent of its taxable income for 1943, and 68 per cent of its taxable income for 1944. In terms of the Duke Optical Company's taxable income as similarly adjusted, the disallowed rebates exceeded 72 per cent of the Com-

² In the taxable years payments were made to as many as 43 physicians. (App. 168-173.)

The year 1942 is involved in the calculation of tax for 1943 because of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, Sec. 6.

pany's taxable income for 1943 and 63 per cent of its taxable income for 1944. (App. 2, 5, 161-175, 176, 179.)

The Tax Court sustained the respondent's adjustments in regard to the rebates (App. 176-196), with Judge Arundell dissenting. (App. 196-199.) The Court of Appeals affirmed the Tax Court's decision. (R. 229.) In the case of petitioner Thomas B. Lilly the income tax deficiencies are \$54,952.67 for 1943 and \$19,301.68 for 1944. In the case of petitioner Helen W. Lilly the income tax deficiencies are \$26,685.29 for 1943 and \$23,167.14 for 1944. (App. 199-200.)

SPECIFICATION OF ERRORS TO BE URGED.

The Court of Appeals for the Fourth Circuit erred:

- 1. In holding that the amounts paid to the physicians were not deductible as ordinary and necessary business expenses under Section 23(a)(1)(A) of the Internal Revenue Code.
 - 2. In holding that the amounts paid to the physicians were not deductible under Section 23(a)(1)(A) because of public policy.
 - 3. In affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT.

 The decision of the Court of Appeals is in conflict with decisions of this Court and decisions of other Courts of Appeals.

Under Section 23(a)(1)(A) a taxpayer may deduct all "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The Court of Appeals did not dispute that the rebates to the physicians were incurred in carrying on a trade or business. Nor did the Court deny that the rebates were "ordinary" and "necessary" outlays in the conduct of the business. Nevertheless the Court disapproved the deduc-

tion on the ground that the allowance would frustrate public policy. But as Section 23(a)(1)(A) readily reveals and as this Court has repeatedly indicated, hat provision specifies its own criteria of deductibility. In applying criteria which are nowhere to be found in the statute, the decision of the Court of Appeals is in sharp conflict with basic prin-

ciples articulated by this Court.

"What class of outlays may, in relation to the federal income tax, be deducted from gross income and in what amount are matters solely for Congress." The "only problem is to ascertain what provisions Congress has made regarding such expenditures as those for which the petitioner claims the right of deduction." McDonald v. Commissioner, 323 U.S. 57, 59 (1944). Here the provisions which Congress has made are quite clear and specific. The expense must be a "business" expense; and it must be both "ordinary" and "necessary." The statute provides no less and no more.

This Court has held that an outlay is a business expense if it "is directly connected with" or "proximately resulted from" the taxpayer's business. Kornhauser v. United States, 276 U.S. 145, 153 (1928). See further Trust of Bingham v. Commissioner, 325 U.S. 365, 373-374 (1945). This Court has also declared that an expense is "ordinary" if it is "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," or "embraced within the normal overhead or operating costs" of the enterprise. An "extremely relevant" consideration "is the nature and scope of the particular business out of which the expense in question accrued." Deputy v. du Pont, 308 U.S. 488, 495, 496 (1940). Or as this Court previously stated in Welch v. Helvering, 290 U.S. 111 (1933), in determining what is ordinary, "we have recourse to any fund of business experience, to any known business pracrices." "The standard set up by the statute is not a rule of law; it is rather a way of life." Hence our guide is "the ways of conduct and the forms of speech prevailingin the business world." Id. at 114, 115. Finally, this Court has held that an expense is "necessary" if it is "appropriate and helpful" in the conduct of the business concerned. Id. at 113. See also Commissioner v. Heininger, 320 U.S. 467, 471 (1943). Cf. Commissioner v. Flowers, 326 U.S. 466, 470 (1946).

In view of the principles enunciated by this Court, the rebates were clearly deductible. In the language of this Court's opinion in Commissioner v. Heininger, supra, at 471; the payments were plainly "both 'ordinary and necessary' if these words be given their common.y accepted meaning." By the same token there was no basis for the Court of Appeals' conclusion other than "some unexpressed spirit outside the bounds of the normal meaning of words." Addison v. Holly Hill Co., 322 U. S. 607, 617 (1944). Needless to say, the rebates were "directly connected" with the petitioners' business. They were intimately related not only to the business, but to the production of income for the business. Cf. Trust of Bingham v. Commissioner, supra, at 373-374. They were certainly "ordinary," since they were "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," and included in "the normal overhead or operating costs" of the business. In paying the rebates the petitioners simply conformed to "the ways of conduct" of the "particular business" in which they were engaged. And the rebates easily qualified as "necessary." Indeed they were more than merely "appropriate and helpful." They were unavoidable if the petitioners were to compete successfully in an industry where the custom of rebates was firmly entrenched through no choice of the petitioners.

The Court of Appeals fell into grave error by assuming that in Commissioner v. Heininger, supra, this Court approved some extra-statutory principle of public policy forbidding the deduction of outlays which are otherwise well within the language of Section 23(a)(1)(A). In the Heininger case this Court observed that "The Bureau of Inter-

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nal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in Section 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct." 320 U.S. at 473. But in making this observation, this Court hardly endorsed by indirection any vague doctrine of public policy as a criterion of deductibility for tax purposes. This Court merely indicated that even the nebulous notion of public policy, which lower courts had at times approved, did not bar the deduction in controversy. See id. at 475. In fact, the Heininger opinion pointedly noted that this doctrine "narrowed the generally accepted meaning of the language used in Section 23(a)." In the same connection the opinion explicitly stated that "the language of Section 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible." And this Court then indicated that the tax laws do not "penalize illegal business by taxing gross instead of net income." Id. at 474. Clearly this statement rejects any vagrant principle of public policy. For under any such theory illegal business should not be allowed any deductions on the ground that deductions aid and encourage taxpayers to engage in unlawful activities.

The rebates incurred by the petitioners were plainly deductible under the Heininger decision. In summarizing the scope of that decision as it applies here, we cannot do better than quote from Judge Minton's opinion in the same case for the Court of Appeals for the Seventh Circuit. "If the deduction in the case at bar was not an ordinary and necessary expense to the 'carrying on' of the business, we are unable to understand the English language. Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that

which gives life is not ordinary and necessary." Heininger v. Commissioner, 133 F. (2d) 567, 570 (C.A. 7, 1943).

Even if the meaning of Section 23(a)(1)(A) is mysteric ously hedged by some doctrine of public policy, the decision of the Court of Appeals is nevertheless in conflict with Commissioner v. Heininger, supra, and decisions of other Courts of Appeals. In Commissioner v. Heininger, supra, the taxpayer was a dentist who made and sold false teeth in a mail order business. The Postmaster General issued a fraud order against him on the ground that his statements tended to mislead prospective customers or to misrepresent the deality of his product. The taxpayer sought an injunction against the fraud order, but his efforts ultimately failed. During the litigation he incurred lawyer's fees and related legal costs, which he later deducted in computing his federal income taxes. As in the present case, the Commissioner strenuously argued that Section 23(a)(1)(A) does not sanction any deduction which contravenes public policy. This Court rejected the argument for reasons which equally apply here and which the Court of Appeals misunderstood.

If the outlays "are to be denied deduction," this Court stated in the Heininger case, "it must be because allowance of the deduction would frustrate the sharply defined policies" of the postal statutes "which authorize the Postinaster General to issue fraud orders. The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators; such punishment is provided by separate statute, and can be imposed only in a judicial proceeding in which the accused has the benefit of constitutional and statutory safeguards appropriate to trial for a crime." Hence it followed "that to allow the deduction" of the expenses "would

The opinion further stated that the postal statutes were not designed to deter alleged offenders from employing counsel in defense to a fraud order.

not frustrate the policy of these statutes; and to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding." Id. at 474-475.

The reasoning of this Court peculiarly applies here. No federal or state statute imposed any "personal punishment" on the petitioners because of their payments to physicians. For that matter the petitioners, unlike the tax-payer in the Heininger case were not subject to any statute or rule of law designed to deter them from the questioned business practice. The payments had not the remotest stigma of illegality. In denying the deduction the Court of Appeals necessarily attached "a serious punitive consequence" upon the petitioners where none was otherwise imposed upon them. The Tax Court has candidly conceded that "the effect" of its decision in this case "was to penalize the optician." See Weather-Seal Manufacturing Co., 16 T. C. No. 158 (1951).

The Courf of Appeals reasoned that the agreements between the petitioners and the physicians were contrary to public policy because the rebates violated the fiduciary responsibility of the physicians to their patients. The alleged violations consisted of the doctor's "secret profits through dealings with his patients." (R. 228.) But even if we extend the utmost credit to this reasoning, the Court of Appeals merely established that the agreements were contrary to public policy in the sense that a physician would not be able to recover upon them. Cf. Reilly v. Beekman, 24 F. (2d) 791 (C. A. 2, 1928), on which the Court of

⁸ The two states which frown on the payment of rebates have considered it necessary to impose penalties by legislation. See California Business and Professional Code (Deering, 1949 Pocket Supp.) §§ 650, 652; Remington's Revised Statutes of Washington, Annotated (1949 Supp.) § 10185-14.

There is no question of tax avoidance. The physicians regularly reported the rebates as taxable income. (Tr. 28, 40, 59-60, 76, 137, 143, 148, 153, 159.)

Appeals relied. The rule of law implicit in the physician's inability to recover is exclusively directed against the physician and is solely designed to prevent him from collecting the promised payment. The rule does not even attempt "to impose personal punishment" on the physician. On no theory would the doctor's inability to enforce payment be deemed a penalty for an unlawful act. See Jerry Rossman Corporation v. Commissioner, 175 F. (2d) 711, 712 (C. A. 2, 1949). In disallowing the deduction of the rebates, the Court of Appeals affirmatively punished the petitioners by virtue of a rule of law which is not at all aimed at them and does not purport to punish anyone else. In short, the petitioners have been punished because the doctors allegedly misbehaved.

Aside from its sharp conflict with this Court's Heininger opinion, the reasoning of the Court of Appeals is irreconcilable with the opinion in Jerry Rossman Corporation v. Commissioner, supra. In that case the Court of Appeals for the Second Circuit held that under the Heininger decision fines and forfeitures are deductible, depending "upon the place of sanctions in the scheme of enforcement of the underlying act." The Court expressly rejected any rigid rule that a taxpayer may not deduct payments resulting from a violation of statute or some other manifestation of policy. 175 F. (2d) at 713. Instead the Court held that a penalty is deductible if the allowance does not "frustrate" any sharply defined policies," of the act imposing the penalty. Under the Rossman decision the petitioners' rebates were clearly deductible, and in holding otherwise the Court of Appeals for the Fourth Circuit contradicted the animating principle of that decision For, in this case, unlike the Rossman case, no "sanction" whatever was imposed upon the petitioners which the deduction could comceivably frustrate. In fact, the petitioners were not even subject to the slightest "scheme of enforcement."

o The decision of the Court of Appeals ultimately rests on the premise that a payment which derives from a private

wrong is non-deductible. This premise collides head-on with decisions of other Courts of Appeals. In Anderson v. Commissioner, 81 F. (2d) 457 (C. A. 10, 1936), the Court of Appeals for the Tenth Circuit approved the deduction of damages assessed against a taxpayer because of negligence resulting in death. In Helvering v. Humpton, 79 F. (2d) 358 (C. A. 9, 1935), the Court of Appeals for the Ninth Circuit sustained the deduction of outlays which the taxpayer incurred because of fraudulent behavior in The course of business. "We cannot agree," the opinion stated, "that private wrongdoing in the course of business is extraordinary within the meaning of the taxing statute allowing deductions for ordinary and necessary expenses. The statute itself makes no such exception Id. at 360.7 As these and many other cases have held, business outlays ' due to private wrongs are deductible expenses though all private wrongdoing is contrary to public policy. The decision of the Court of Appeals is necessarily in conflict with this rule, even if we assume, as the respondent contends, that the petitioners were parties to a civil wrong.

II. The proper disposition of this case involves an important question of law which should be settled by this Court.

This case raises a critical question in the administration of the federal income tax laws. Nothing in Section 23(a) (1)(A) or in any Treasury regulation grants or denies deductions in terms of "public policy." Cf. Commissioner v.

7 In the Heininger case this Court seems to have approved the Hampton decision. See 320 U.S. at 472, n. 6.

See Becker Bros. v. United States, 7 F. (2d) 3 (C. A. 2, 1925) (infringement of patent); H. M. Howard, 22 B. T. A. 375 (1931) (misrepresentation and conspiracy); W. R. Hervey, 25 B. T. A. 1282 (1932) (violation of usury laws); International Shoe Co., 38 B. T. A. 81 (1938) (conspiracy); Robert S. Farrell, 44 B. T. A. 238 (1941) (unlawful acts as director); William Ziegler, Jr., 5 T. C. 150 (1945) (mismanagement of corporation). See further I. T. 3627, C. B. 1946, p. 111; I. T. 3762, C. B. 1945, p. 95; O. D. 978, C. B. 5, p. 135 (1921).

Heininger, supra, at 470.9 The statute specifically states what outlays are deductible. May the respondent, in his discretion, suspend the operation of Section 23(a)(1)(A) in the name of "public policy" where that provision otherwise clearly grants a business deduction? May the respondent, in supposedly enforcing the income tax, exercise the prerogatives of a self-appointed censor of business practices?

Needless to say, these issues spread far beyond this immediate case. They reach into every nook and cranny of. business life which is increasingly controlled and supervised by government. Each public regulation reflects a "public policy," and any outlay due to a deviation from that "policy" is necessarily involved in the principle which the respondent seeks to apply. Nor does the reach of this principle pause at the shifting borders of public regulation. As the Court of Appeals' decision vivally illustrates, the principle cuts deep into the whole complex of private relations between businessmen. Indeed no limitation is in sight, for a principle of so-called "public policy" is conveniently free from any restrictions which a rule of tax law normally implies. io "The meaning of the phrase 'public policy' is vague and variable; there are no fixed rules by which to determine what it is." Steele v. Drummond, 275 U.S. 199, 205. (1927).114 See also Twin City Co. v. Harding Glass Co., 4 283 U. S. 353, 356 (1931). The answer given by the Court of Appeals in this case assures a swelling volume of litigation unless this Court expeditiously intervenes. Cf. Moline Properties v. Commissioner, 319 U. S. 436 (1943).

Aside from denying deductions for federal tax penalties, the regulations broadly authorize the deduction of "ordinary and necessary expenditures directly connected with or pertaining to the tax-payer's trade or business." Regulations 111, § 29:23(a)-1.

ia Compare I. T. 3724, C. B. 1945, p. 57, and I. T. 3811, C. B. 1946-2, p. 70, with Lela Sullenger, 11 T. C. 1076 (1948).

in In the same case this Court warned that the principle of public policy "must be cautiously applied to guard against confusion and injustice." See id. at 205.

Already the opinions of the Courts of Appeals are hopelessly confused.12 And the difficulties which nourish the confusion "can neither be met nor avoided by spurious interpretations of tax provisions dealing with allowable deductions." McDonald v. Commissioner, supra, at 63. For example, the Fifth Circuit has stated that under "the broad definition of gross income, income arising from an illegal. business is taxed even though the illegality be one declared by the Constitution itself . . . The provisions of the statute fixing the deductions to be regarded in arriving at the net income which alone is taxed . . . are as broad and unqualified as those defining the taxable gross income." Alexandria Gravel Co. v. Commissioner, 95 F. (2d) 615, 616 (C. A. 5, 1938). See also Heininger v. Commissioner, supra, at 569. According to another view, fines and penalties are never deductible as business expenses, whether they are deliberately or inadvertently incurred. See, e.g., Great Northern Ry. v. Commissioner, 40 F. (2d) 372 (C. A. 8, 1930), cert. denied, 282 U.S. 855 (1930); Chicago, Rock Island & Pucific Ry. Co. v. Commissioner, 47 F. (2d) 990 (C. A. 7, 1931), cert. denied, 284 U.S. 618 (1931). On the other hand, it has been held "that there are 'penalties' and 'penalties', and that some are deductible and some are not." The determinative factor is "the place of sanctions in the scheme of enforcement of the underlying act," and "in every case the question must be decided ad hoc." Jerry Rossman Corporation v. Commissioner, supra, at 713. According to still another view, penalties are deductible unless they are due to "an unreasonable lack of care." National Brass Works v. Commissioner, 182 F. (2d) 526, 530 (C.A. 9, 1950).

The confusion does not abate when we pass beyond the realm of public regulations into the realm of private rela-

¹² We should also note that the Treasury, too, is often confused in applying its doctrine of public policy. For instance, compare P. H. 1950 Fed. Tax Law, Par. 76,321, with I. T. 4042, Int. Key, Bull., 1951, No. 1, p. 3.

tions. As previously noted, many decisions have held that a business outlay attributable to a private wrong is a deductible expense. See p. 12, supra. In contrast, the Court of Appeals has held in this case that an outlay reflecting an alleged transgression of private rights is not deductible. Unless "an arbitrary line" is drawn, it is quite a job to reconcile the decisions which allow the deduction of expenses deriving from a private wrong with the decisions which deny the deduction of outlays deriving from a public wrong. Burroughs Building Material Co. v. Commissioner, 47 F. (2d) 178, 180 (C. A. 2, 1931). In both cases "public policy" is equally involved and equally violated. Business fines and penalties have been disallowed on the ground that a tax deduction would partially mitigate the sanction incurred. See Great Northern Ry. v. Commissioner, supra, at 373; Commissioner v. Longhorn Portland Cement Co., 148 F. (2d), 276, 277 (C. A. 5, 1945), cert. denied, 326 U.S. 728 (1945). But the deduction of damages / imposed because of a private transgression equally mitigates the sanction imposed upon a taxpayer for his wrongful conduct.18

The decision of the Court of Appeals in this case nicely exemplifies the endless confusion which the principle of "public policy" inevitably breeds. The Court of Appeals did not deny that the questioned payments, apart from public policy, qualified as ordinary and necessary business expenses. However, the Court reasoned that the payments were not deductible because they failed to satisfy the standards of equity as compared with the standards of the market place. In support the Court quoted Mr. Justice Car-

such as for bribery of public officials to secure protection of an unlawful business, would not have to be allowed in order consistently to justify a deduction of fines paid for violations of law involving no moral turpitude and practically inevitable." Burroughs Building Material Co. v. Commissioner, supra, at 180. Cf. Id. O. 1092, C.B.Id., p. 270 (1922), distinguishing between illegal transactions and merely unenforceable contracts.

dozo's famous admonition that many "forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Meinhard v. Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546 (1928). This quotation leaves no doubt of the Court of Appeals confusion. The present controversy is not a suit in equity, nor was Section 23(a)(1)(A) devised as a means of enforcing the standards of equity as they may variously evolve in the state courts. The question in this case is one of federal income tax liability, and the answer turns on the meaning of a statute devoted to "the single uniform purpose of federal taxation." Estate of Rogers v. Commissiener, 320 U.S. 410, 414 (1943). See also Lyeth v. Hoey, 305 U.S. 188, 193 (1938); United States v. Pelzer, 312 U.S. 399, 402 (1941). That purpose contemplates a tax on business income after allowance for all business expenses which are "ordinary" and "necessary" according to "the ways of conduct and the forms of speech prevailing in the business world." Commissioner v. Heininger, supra, at 471. In its anxiety to apply a principle of equity, wholly unrelated to federal taxation, the Court of Appeals overlooked the language and policy of Section 23(a)(1)(A). Just as the allowance of deductions under that provision does not depend upon "equitable considerations" (Deputy v. du Pont, supra, at 493), neither does their denial.14

The Court of Appeals' opinion additionally indicates that public policy' easily leads into a quagmire of conceptualism divorced from relevant fact. The opinion argued that the agreements between the petitioners and the physicians were unenforceable because they tended to corrupt the latter into prescribing unnecessary or unduly expensive glasses, recommending an inferior optician, and artificially increasing the price of glasses. However, the record establishes that the physicians' services and the petitioners' prices remained the same, whether or not the referred patient bought his spectacles from the petitioners. Moreover, the payment of rebates was not a practice inaugurated by the peti-

A principle which is confusing and elusive in content is inevitably harsh and retroactive in application,15 Again this case serves as a grim illustration. For many years opticians, including the petitioners, excluded the rebates from their taxable net income and the respondent's agents repeatedly approved the exclusion. Since the rebates were a substantial portion of the opticians' gross receipts, the exclusion was necessarily a vital factor in business assumptions, calculations and risks. In the present case the rebates of the City Optical Company for 1942, 1943 and 1944 aggregated \$178,687.05 (App. 179), as compared to a total book value of only \$76,191.32 as of December 31, 1942. (14 T. C. at 1068.) Again, for 1943 and 1944 the rebates of the two Companies varied between 61 per cent and 72 per cent of their taxable income as adjusted by the respondent.16 Despite its long-continued administrative practice and without any prior warning of a change in position, the Treasury has now reversed itself in the name of public policy. Disastrous financial consequences are inescapable under the retroactive impact of the principle pursued by the respondent. Surely in enacting Section 23(a)(1)(A) Congress did not contemplate "so deadly a remedy" which no word in that statute implies or suggests. Cf. Bruce's Juices, Inc. v. American Can Co., 330 U.S. 743, 754 (1947).

15 We need hardly remind this Court of the evils of retroactivity in income taxation. See, e.g., Helvering v. Griffiths, 318 U. S. 371, 402-403 (1943); Claridge Apartments Co. v. Commissioner, 323

tioners in order to corrupt physicians, but a widespread custom enforced by physicians, to which the petitioners had to conform in order to compete. Again, the practice of rebates no more corrupted the physicians than the other custom whereby physicians lawfully purchased glasses at a wholesale price and resold them at a retail price. Nor is the physician who receives a rebate more tempted to do what the Court of Appeals feared than the physician who runs his own optical business and therefore has a potential financial stake in prescribing glasses. All these considerations sharply underscore the futility of using tax law as a means of policing the integrity of eye doctors.

U. S. 141, 164 (1944).

¹⁶ See p. 4, supra.

The present confusion over a steadily expanding area urgently requires the authoritative intervention of this Court. The respondent frankly regards Section 23(a)(1) (A) as a special delegation of power to regulate and disapprove business standards and procedures. As this case reveals, the respondent even assumes that the vast area of professional ethics equally falls within his alleged powers of supervision. Section 23(a)(1)(A) has been converted into a federal policies provision employed to implement not only federal policies, but state policies having nothing to do with federal taxation.

The respondent's view of Section 23(a)(1)(A) completely disregards the clear purport and plain function of that provision. "The revenue act was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the State inflicts." Nor was that act contrived in order to assure that businessmen abide by local principles of equity. The respondent's reliance on some notion of public policy is mere question begging. To borrow Mr. Justice Holmes' memorable phrase, the public policy of taxation is not "a brooding omnipresence in the sky" (Southern Pacific Co. v. Jensen, 244 U.S. 205, 222 (1917)) whose aid the respondent may periodically invoke as he sees fit. The public policy of taxation is the policy which Congress creates, and that policy is expressed in the taxing provisions which Congress has enacted.

In so far as Section 23(a)(1)(A) is concerned, the basic policy of Congress is well beyond the pale of doubt. That provision was not imposed in order to create or enforce a code of business or professional ethics. Certainly there is no indication that the respondents' agents are particularly skilled in the art of regulating trade practices as distinguished from the art of computing and collecting taxes. The sole objective of Section 23(a)(1) (A) is to confine the

¹⁷ Member Sternhagen, in Burroughs Building Material Co., 18 B. T. A. 101, 105 (1929).

burden of the income tax to net income. "The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax paying group." Higgins v. Smith, 308 U.S. 473, 476-477 (1940). "Taxation on net, not on gross, income has always been the broad basic policy of our income tax laws. Net income may be defined as what remains out of gross income after subtracting the ordinary and necessary expenses incurred in efforts to obtain or to keep it." Black J., McDonald v. Commissioner, supra, at 66-67. See also id. at 68-69. Hence Section 23 (a)(1)(A) assures the deduction of "outlays in the efforts or services" from which "income flows." Frankfurter J., id. at 60-61. See also Roberts, J., in Deputy v. du Pont, supra, at 500.

In misapplying Section 23(a)(1)(A) the Court of Appeals has raised fundamental issues concerning the scope of that significant statute. Only this Court can set those issues at rest.

Conclusion.

For the foregoing reasons it is respectfully submitted that this petition for a writ of certiorari should be granted.

RANDOLPH E. PAUL,
LOUIS EISENSTEIN,
Counsel for the Petitioners.

Office Supreme Court, U. S. FILED

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CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

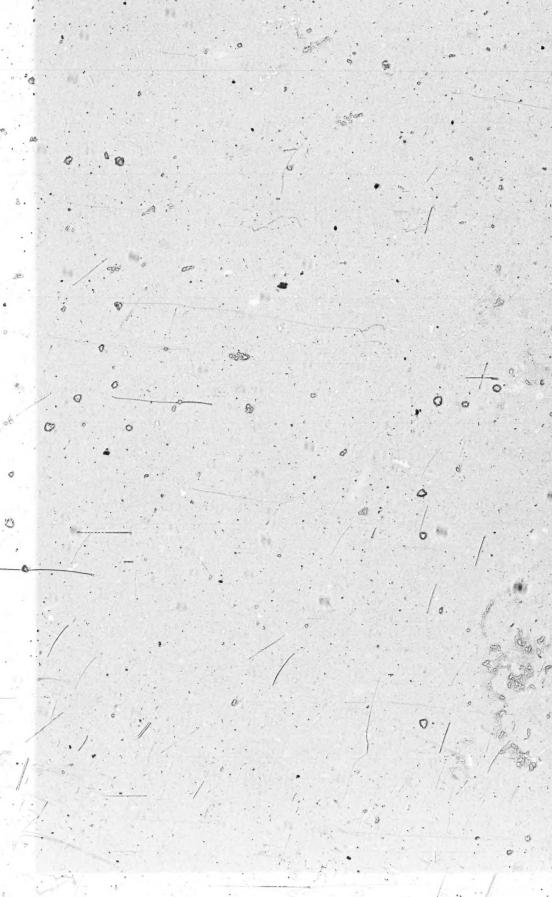
THOMAS B. LILLY AND HELEN W. LILLY, Petitioners,

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COMMISSIONER OF INTERNAL REVENUE Respondent.

REPLY BRIEF FOR PETITIONERS

RANDOLPH E. PAUL, Louis Eisenstein, Counsel for the Petitioners.



IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

THOMAS B. LILLY AND HELEN W. BILLY, Petitioners,

COMMISSIONER OF INTERNAL REVENUE, Respondent.

REPLY BRIEF FOR PETITIONERS

The respondent's brief in opposition indulges in a number of misconceptions, both factual and legal. We wish to call the Court's attention to some of the more basic errors.

1. The respondent has sought to envelop the petitioners in an atmosphere of evil and corruption which he apparently attributes to them. As the petitioners have stated and as the record clearly reveals (Pet. 3-4), the payment of rebates to doctors was a settled industry practice when the petitioners entered the optical field. In order to survive

The respondent does not deny that the evidence to this effect is clear and uncontradicted. Instead he resorts to the frail excuse that the evidence consists of "statements, often self-serving of various witnesses." (Resp. 15.) The evidence in question was direct oral testimony subject to the usual safeguards provided by cross-examination.

the petitioners had to pursue an established practice which was not of their own choosing. To suggest that the petitioners initiated a policy of corrupting physicians is to indulge in naive imagination.² Needless to say, the petitioners would have been very glad to retain the sums paid to the doctors if competitive conditions had permitted them to do so.³

The various medical resolutions and editorials quoted by the respondent graphically indicate that the custom of rebates was a widespread business practice. In 1946 the Department of Justice was "informed that the rebating practice is industry wide." The Department meticulously supplied details which embraced Chicago, Dallas, Oklahoma City, Minneapolis, and Denver. In a number of instances the rebates taken by the physicians exceeded the sums retained by the opticians. The Department stated that "some individual physicians receive as much as \$40,000 annually in rebates." "Moreover, the actual cumulative figures indicate that one group of physicians in Iowa received more than \$42,000. One physician in a small town in Texas received almost \$15,000, a sum equaled by physicians in Minneapolis, Waterloo, Iowa, Rockford, Ill., and other small communities. Since the practice was so widespread, there were several resolutions on the subject in the American Medical Association. Nor has the physicians' practice of taking relates been carefully confined to eye-glasses. Doctors have similarly engaged in the practice of obtaining rebates from phe macists and makers of braces and splints. "The development of roentgenology as an important medical specialty and the establishment of clinical pathologic laboratories to which physicians send patients for the making of highly technical and often costly tests have intro-

⁵ Nor is there the least suggestion in the evidence that any doctor was corrupted.

³ The respondent points out that a competitor of the petitioners discontinued the same practice after the taxable years in question. (Resp. 8.)

duced new sources of rebates, kickbacks and commissions." (Resp. 8-9, 21-26.)

2. The opening premise of the respondent's argument is that he who seeks a deduction must "show that he comes within the terms of an applicable statute." (Resp. 11.) This assertion has a peculiarly strange ring in this case. For it is the respondent who has ignored "the terms" of the statute in order to disallow the deduction. The respondent's views rest not on the statute, but on some nebulous doctrine of public policy which nowhere appears in the statute. The Tax Court put the matter quite bluntly in the words of that Court, the payments "are not deductible as ordinary and necessary expenses because the contracts under which these payments were made violated public policy." (R. 196.)

3. The respondent's position does not improve when he denies the existence of a conflict with decisions of this Court and other Courts of Appeals. (Resp. 18-19.)

As regards Commissioner v. Heininger, 320 U. S. 467 (1943), the respondent merely echoes the same view which this Court rejected in that case. There, as here, the Government argued that its position was "supported by a number of decisions denying the deduction of expenditures incurred as the result of activities which were illegal or contrary to public policy." Brief for the Petitioner, p. 12, Commissioner v. Heininger, supra. But as this Court held, even under a principle of public policy a business outlay is deductible unless the deduction would "frustrate" some "sharply defined" policy directed against the taxpayer. 320 U. S. at 474. The Court found no such "sharply defined" policy in the Heininger case, where the expenses were occasioned by fraudulent practices via the mails which contravened specific federal statutes. In this confection

⁴ The anti-trust suit to which the respondent refers (Resp. 15. n. 4) was directed against price fixing and not rebates as such. See R. 202-221. The Court below placed no reliance on that suit, to which the petitioners were not parties.

the Court emphasized that those statutes did not purport to impose any penalties for the proscribed conduct. The reasoning of the *Heininger* case is a fortiori applicable here. In paying the rebates the potitioners did not incur any penalty which the deduction would mitigate. Indeed they did not incur any sanction whatsoever which a deduction might conceivably "frustrate."

In Jerry Rossman Corporation v. Commissioner, 175 F. 2d 711 (C. A. 2, 1949), the Court of Appeals for the Second Corcuit held that a deduction which is otherwise allowable under Section 23(a)(1)(Å) may not be disallowed unless the deduction would "frustrate" a sanction imposed on the taxpayer. The Court further held that the same rule applied even if the sanction was a penalty. The decision below is necessarily in conflict with the Rossman decision beer se under no circumstances could the deduction "frustrate" any sanction directed against the petitioners.

The respondent's attempt to distinguish Anderson v. Commissioner, 81 E. 2d 457 (C. A. 10, 1936), and Helvering v. Hampton, 79 F. 2d 358 (C. A. 9, 1995), completely misses the point of his so-called public policy doctrine. If that doctrine properly applies, those cases were erreneously decided. According to the respondent's doctrine of public policy, an outlay reflecting a legal wrong is not deductible because a deduction would mitigate or encourage the consequences of the proscribed conduct. Nevertheless in the Anderson and Hampton cases deductions attributable to negligence and fraud were sustained. The respondent's effort, for the purposes of this case, to distinguish the deduction of civil damages has been appropriately labeled "arbitrary." See Note, 54 Harv. L. Rev. 852, 856 (1941); Pet. 15. On other occasions the respondent has similarly disparaged the distinction. See, e. g., Helvering v. Hamp-

[•] In the Rossman case itself the Second Circuit decided that there was no "frustration" because the violation concerned was innocent. The matter of innocence related only to the question whether the particular sanction involved in that case would be "frustrated."

ton, supra, at 359; International Shoe Co., 38 B. T. A. 81, 95 (1938).

4. In final analysis the respondent is invoking some extra-statutory principle which is conveniently "unconfined and vagrant." Cf. Schechter Corp. v. United States, 295 U. S. 495, 551 (1935). The respondent would disallow all deductions which he considered against public policy. Obviously there are no discernible limits to the powers of censorship which the respondent would eagerly assume in the process of collecting taxes. For public policy is essentially indefinable unless vague generalities are considered a definition. The Tax Court's opinion in this case is extremely illuminating in this respect.

That Court defined public policy as "the public good. Everything that tends clearly to undermine that sense of security of individual rights, whether of personal liberty or private property, which any citizen ought to feel, is against public policy." Next the Tax Court redefined public policy as "the community common sense and common conscience extended and applied throughout the state to matters of public morals, public health, public safety, public welfare, and the like; it is that general and well settled public opinion relating to man's plain, palpable duty to his fellow men, having due regard to all the circumstances of each particular relation and situation." the Court further defined public policy as prohibiting "that which has a tendency to be injurious to the public welfare." (14 T. C. at 1079-1080.) Surely in allowing the deductionof "ordinary and necessary" business expenses Congress did not authorize the respondent to censor deductions according to his notions of "security of individual rights"; "common sense and common conscience"; "public morals?" public health, public safety, public welfare, and the like" "man's plain, palpable duty to his fellow men." Yet the decision below hardly authorizes the respondent to do less.

The vast implications and consequences of the decision below were acutely anticipated in a penetrating appraisal of the respondent's public policy doctrine:

"Once the courts attempt to deter indesirable business activity through the disallowance of various business expenditures, they must face a series of increasingly indefinite factual situations. The simplest is where the expenditure may be considered the penalty of a previous adjudication of unlawful conduct; these are the fines, judgments, and legal expenses. The Courts have said that public policy requires this method of deterrence only where there has been a prosecution by the government. The second situation is where either the actual expenditure or the activity in which it was incurred is in violation of law; here the expenditure is habitually disallowed. The third factual situation differs from the second in that while the activity is not in violation of law, nevertheless it is considered contrary to the best public interest.

"In the first two situations, the sources of policy are confined to the criminal and regulatory statutes. Its application is limited to the general deterrence of violations of criminal statutes, and, in regulatory statutes, where there has been a previous adjudication of violations. In the third situation, the sources of public policy are not thus restricted; presumably these sources may be any expression, whether of judicial or legislative origin, of which activities are inimical to the public interest. The only limitations would appear to be two inarticulately expressed judicial standards:

the ideal business man and the public welfare.

"The rule in the first two situations may perhaps be justified by a principle of statutory construction that the word 'lawful' may be read before a word of 'all-inclusive import'—in this case, before the word 'expense.' But even this principle is unavailing in the third situation, and justification of disallowances on grounds of effectuating public policy must overcome both the contrary import of the statutory language and the countervailing policy against the judicial conversion of a tax on net income into a possibly exorbitant tax on gross receipts. In addition, the extension of the concept of illegality arising from criminal and

regulatory statutes to the concept of effectuation of public policy involves the acceptance en masse of all the artificiality such a vague standard must necessarily contain. The negligible relation of such a standard to the determination of what the tax burden of an individual taxpayer should be indicates that even though the restricted concept of illegality be retained, the broad concept of effectuating public policy should be discarded. To do so will, of course, result in the loss of haphazard additions to the national revenue. But increases in revenue should come either from an extension of tax liability or from an increase in rates, rather than from the distortion of a relatively rational system of taxation." Note, 54 Harv. L. Rev. 832, 858-860 (1941).

Respectfully submitted,

RANDOLPH E. PAUL,
LOUIS EISENSTEIN,
Counsel for the Petitioners.

FUPREME OURT.U.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

No. 158.

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

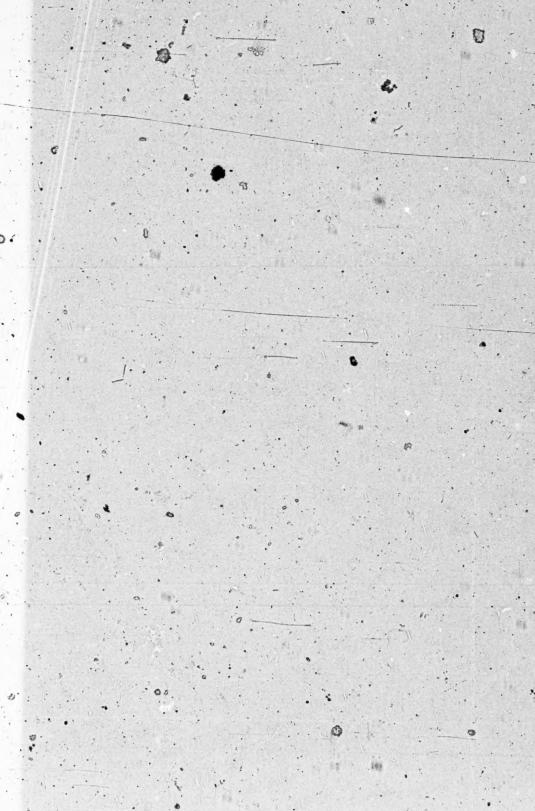
COMMISSIONER OF INTERNAL REVENUE, Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuits

BRIEF FOR THE PETITIONERS.

RANDOLPH E. PAUL, Counsel for the Petitioners.

HENRY LEHRICH, LOUIS EISENSTEIN, Of Counsel.



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IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

No. 158.

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

COMMISSIONER OF INTERNAL REVENUE, Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

BRIEF FOR THE PETITIONERS.

OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 176-196), Judge Arundell dissenting (R. 196-199), is reported in 14 T. C. 1066. The opinion of the United States Court of Appeals for the Fourth Circuit (R. 224-229) is reported in 188 F. 2d 269.

JURISDICTION.

The judgment of the United States Court of Appeals was entered on April 2, 1951. (R. 229.) A petition for a writ of certiorari was filed on June 29, 1951, and was granted on October 8, 1951. (R. 193.). The jurisdiction of this Court rests on 28 U.S.C. Section 1254(1), 62 Stat. 928.

QUESTION PRESENTED.

During the taxable years the petitioners were engaged in the optical business. Pursuant to agreements with various eye doctors, which reflected an established and widespread industry practice, the petitioners regularly credited and paid one-third of the price received for glasses to the doctor who prescribed the glasses for the customer. The question presented is whether the amounts credited and paid to the doctors were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as ordinary and necessary expenses of doing business.

STATUTE AND REGULATIONS INVOLVED.

Internal Revenue Code:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

- (a) Expenses.
 - (1) Trade or business expenses.
 - (A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business....

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.21-1. Meaning of Net Income.—... The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less cer-

tain eredits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income....

See. 29.23(a)-1. Business Expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23(b) to 23(z), inclusive, and the regulations thereunder....

STATEMENT.

The petitioners are husband and wife, who in 1942, 1943 and 1944 were engaged in the optical business. As partners they owned and operated the City Optical Company, with offices in Wilmington, Fayetteville, and Greensbere, North Carolina, and in Richmond, Virginia. Petitioner Helen W. Lilly also owned and operated the Duke Optical Company in Fayetteville, North Carolina. (R. 163, 176-177.)

For many years before 1920 eye doctors or oculists customarily sold glasses to their patients. After examining the patient's eyes, the doctor would buy the necessary frame and lenses from a wholesale optician, and then resell the finished glasses to the patient. The doctor would keep the difference between the wholesale price paid to the optician and the larger retail price paid by the patient. Many doctors still do their own "dispensing," that is, they buy the lenses and frame and resell them to the patient. The physician's gain consists of a fee for services and the difference between the wholesale price and the retail price of the glasses. (R, 8, 23, 38, 41-42, 47, 69, 76, 77, 86, 111-112, 125, 179.)

In 1922, when petitioner Thomas B. Lilly organized the City Optical Company, another practice was firmly established in the optical industry. Instead of buying, and re-

selling the glasses, many doctors referred their patients to designated opticians, who would directly furnish and fit the glasses, and charge the patients a retail price. Pursuant to agreement between the optician and the doctor, the former would remit a portion of the retail price to the latter. It was felt that this arrangement was superior to the other because the patient obtained better service when the optician fitted and adjusted the glasses. (R. 8, 9, 33, 47, 59, 65-66, 69, 75-76, 81, 86, 114, 125, 142-143, 176.)

The practice of making payments to doctors was wide-spread throughout the taxable years 1943 and 1944, as well as the intervening years after 1922. In accordance with this trade practice the petitioners paid a number of doctors one-third of the price received on the sale of glasses to their patients. The petitioners would not have been able to operate successfully if they had failed to abide by this established practice. Physicians were unwilling to surrender the available differential between the wholesale and retail prices unless they were assured of the castomary payments. (R. 8-10, 22-23, 33, 65-66, 69, 76, 81, 86, 107, 110-111, 114, 115, 125, 131, 176.)

The respondent determined deficiencies for 1943 and 1944 on the ground that the payments to the doctors were not deductible items. He therefore increased the petitioners' taxable income in the following amounts for the following years:

1	City Optical	Duke Optical
Year	Company	Company
1942	\$57,063.45	
1943,0	61,601.95	\$6,568.87
1944	60,021.65	4,798.35

In terms of the City Optical Company's taxable income, as recomputed by the respondent, the disallowed payments

^{&#}x27;In the years involved payments were made to as many as 43 physicians. (R. 168-173.)

² The year 1942 is involved in the calculation of tax for 1943 because of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, Sec. 6:

exceeded 56 per cent of the Company's taxable income for 1942, 61 per cent of its taxable income for 1943, and 68 per cent of its taxable income for 1944. In terms of the Duke Optical Company's taxable income as similarly adjusted, the disallowed payments exceeded 72 per cent of the Company's taxable income for 1943 and 63 percent of its taxable income for 1944. (R. 2, 5, 161-175, 176, 179.)

The Tax Court sustained the respondent's adjustments (R. 176-196), with Judge Arundell dissenting. (R. 196-199.) The Court of Appeals affirmed the Tax Court's decision. (R. 224-229.) In the case of petitioner Thomas B. Lilly the income tax deficiencies are \$54,953.67 for 1943 and \$19,301.68 for 1944. In the case of petitioner Helen W. Lilly the income tax deficiencies are \$26,685.29 for 1943 and \$23,167.14 for 1944. (R. 199-200.)

SPECIFICATION OF ERRORS TO BE URGED.

The Court of Appeals for the Fourth Circuit erred:

- 1. In holding that the amounts paid to the physicians were not deductible as offinary and necessary business expenses under Section 23(a)(1)(A) of the Internal Revenue Code.
- 2. In holding that the amounts paid to the physiciana were not deductible under Section 23(a)(1)(A) because of public policy.
 - 3. In affirming the decision of the Tax Court.

SUMMARY OF ARGUMENT.

The sums paid to the physicians were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as "ordinary" and "necessary" expenses of doing business.

A. The income tax is a levy on "net income," as distinguished from "gross income." For present purposes Section 23(a)(1)(A) defines "net income" as "gross income"

³ Minor portions of these deficiencies are due to issues abandoned by petitioner Thomas B. Lilly.

less "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The regulations add that "net income" is accordingly "commercial net income," determined in the fight of "commercial usage." This basic principle has been reiterated and emphasized in this Court. Hence Section 23(a)(1)(A) is simply designed to assure a tax on a businessman's net accretion in wealth during the taxable year. The statute does not seek to regulate or improve trade practices and customs as they are reflected in the operating costs of a business. Nor does it seek to penalize undesirable practices and customs by disallowing the expenses which they entail and taxing more than "commercial net income."

This view of Section 23(a)(1)(A) is confirmed by the legislative history of the 1913 Act. During the Senate debate on that Act two attempts were made to disallow the deduction of "illegitimate" or "unlawful" business outlays. The proposed amendments were rejected on the ground that the only objective "is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or slosses." The Senate deliberately rejected the effort to tax more than "actual profit during the year" for the sake of reforming "men's moral characters."

Apart from any nebulous notion of public policy, the payments to the physicians clearly qualified as deductible items under Section 23(a)(1)(A). The payments were directly connected with the petitioners' business, and they were both "ordinary" and "necessary,"

B. In order to sustain his position the respondent has invoked the so-called doctrine of public policy. This doctrine is a clear departure from Section 23(a)(1)(A): Aside from its plain disregard of the language and policy of the statute, the doctrine cannot be adequately justified as a basis for denying business deductions. Both the courts and the respondent have experienced considerable difficulty in rationalizing and applying the doctrine. Even if the doctrine might properly apply where a federal statute has been

violated, it does not properly apply where local policies are involved. Section 23(a)(1)(A) was not designed to enforce canons of business behavior or professional ethics as they may variously evolve in the local courts.

C. The respondent erroneously assumes that in Commissioner v. Heininger, 320 U.S. 467 (1943), this Court approved an extra statutory principle, of public policy. In fact, there are several significant indications in the Heininger opinion that this Court was dissatisfied with the doctrine. Furthermore, the payments to the physicians in this case were clearly deductible under the Heininger decision. Here, as in the Heininger case, the denial of the deduction would penalize the petitioners by taxing them on "gross instead of net income."

D. Even if Section 23(a)(1)(A) is hedged by some dectrine of public policy, the payments were deductible. No federal or state statute imposed any "personal punishment" on the petitioners which a deduction might possibly "frustrate." The questioned payments had no stigma of illegality. The petitioners were not subject to any rule of law designed to deter them from making the payments. As in the Heininger case, the respondent has sought to attach "a serious punitive consequence" upon the petitioners which Congress did not expressly or impliedly impose. In sustaining the respondent's views, the Court of Appeals has affirmatively punished the petitioners by virtue of a rule of private law which is not aimed at them and does not attempt to punish anyone else.

E. The issue before the Court spreads far beyond this case. If the respondent may deny deductions on the basis of public policy, there is no discernible limitation upon his power to censor business outlays. Certainly the respondent does not have any modest notion of his powers of censorship. On at least two occasions he sought to disallow the deduction of "tips," and on another occasion he similarly attempted to disallow a charitable deduction. Since the respondent's principle of public policy is unconfined and elusive in content, it is inevitably harsh and retroactive in

application. In enacting Section 23(a)(1)(A) Congress did not authorize the respondent to pass upon the social desirability of business outlays and to evince his displeasure by taxing gross income.

ARGUMENT.

The Amounts Paid to the Doctors Were Deductible as Ordinary and Necessary Business Expenses Under Section 23(a)(1)(A) of the Internal Revenue Code, and the Deduction of These Amounts Was Not Prohibited by Any Principle of Public Policy.

The issue in this case is simply stated. May the respondent disallow the deduction of business expenses merely because he regards them as socially undesirable? In assuming that he enjoys this sweeping power to censor business practices, the respondent has ignored the governing statute, the related regulations, an illuminating legislative history, and principles articulated by this Court. He has also failed to remember that one should not indulge in "great thoughts about a tax problem unless the thoughts are firmly based on the controlling statute." Griswold, Cases and Materials on Federal Taxation, p. 14 (2d ed. 1946).

A. The income tax is a levy on net income. In the words of the regulations, "The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less certain credits." As the regulations further state, "net income is a statutory conception." Regulations 111, Sec. 29.21-1. For present purposes the relevant aspects of the concept are delineated in Sections 21(a), 22(a) and 23(a)(1)(A) of the Internal Revenue Code. Section 21(a) defines "net income" as "the gross income computed under section 22, less the deductions allowed by section 23." Section 22(a) provides that "gross income" includes "gains, profits, and income" derived from "trades" and "business." Section 23(a)(1)(A) subtracts from "gross income" all "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

Section 23(a)(1)(A) is supplemented by Treasury regulations which broadly authorize the deduction of "ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business." Regulations 111, Sec. 29.23(a)-1. In addition, the regulations provide that while "taxable net income is a statutory conception, in follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income." Regulations 111, Sec. 29.21-1.

The same fundamental principle has been reiterated and emphasized in this Court. See Commissioner v. Heininger, supra, at 474. For Section 23(a)(1)(A) assures the deduction of "outlays in the efforts or services" from which "income flows." Frankfurter, J., in McDonald v. Commissioner, 323 U. S. 57, 60-61 (1944). "Taxation on net, not on gross, income has always been the broad basic policy of our income tax laws. Net income may be defined as what remains out of gross income after subtracting the ordinary and necessary expenses incurred in efforts to obtain or to keep it." Black, J., id. at 66-67. See also id. at 68-69; and Roberts, J., in Deputy v. du Pont, 308 U. S. 488, 500 (1940).

By the same token Section 23(a)(1)(A) is not an essay in morality, designed to encourage virtue and to discourage sin. The provision is more modestly concerned with 'commercial net income'—a businessman's net accretion in wealth during the taxable year. The statute does not attempt to regulate or improve trade practices and customs as they are reflected in the operating costs of a business.

⁴ The regulations specifically exclude federal fax penalties from the realm of business deductions. But cf. Greene Motor Co., 5 T. C. 314 (1945), which relies on Commissioner v. Heininger, 320 U. S. 467 (1943).

⁵ Of course, within constitutional limitations Congress may use the tax laws for vital non-fiscal purposes. However, in enacting Section 23(a)(1)(A) Congress was not motivated by such objectives. And where Congress has wished to deny tax deductions as a

Nor does it attempt to penalize undesirable practices and customs by disallowing the expenses which they entail and taking more than "commercial net income." On the contrary, Section 23(a)(1)(A) accepts and applies trade practices and customs in measuring the net profit of an enterprise.

If, for some reason, the text and context of Section 23(a)(1)(A) leave any doubt in this regard, the doubt should be fully dispelled by the legislative history of the 1913 Act. That Act, which introduced our modern income tax system, similarly granted a deduction for business expenses. 1913 Act, Sec. II(A) and (G)(b). During the debate on that Act the issue here involved was squarely posed and resolved. The legislative discussion clearly indicates that in authorizing a deduction for business outlays, Congress did not seek to police, prohibit or punish trade practices by withholding tax deductions.

The bill, as reported by the Senate Finance Committee, granted individuals a deduction for the "necessary expenses actually paid in carrying on any business," and accorded corporations a similar deduction for "all the ordinary and necessary expenses paid within the year in the maintenance and operation" of their "business and properties." The same section authorized individuals to deduct "losses actually sustained during the year, incurred in trade," and permitted corporations to deduct "all losses

means of reinforcing the sanctions of other federal statutes, it has explicitly so provided. See Section 5(a), Stabilization Act of 1942, 56 Stat. 767 (1942), 50 U. S. C. A. App. § 965 (a); Defense Production Act of 1950, § 405 (b), 64 Stat. 807 (1950), 50 U. S. C. A. App. § 2105; Defense Production Act Amendments of 1951, Pub. U. No. 96, 82d Cong., 1st Sess. § 104(i) (1951).

discussion of pending legislation in highly relevant in determining the policy and scope of a statute. Helvering v. Griffiths, 318 U.S. 371, 380-387 (1943); United States v. Lovett, 328 U.S. 303, 308-310 (1946); United States v. Congress of Industrial Organizations, 335 U.S. 106, 115 (1948).

actually sustained within the year." Seidman, Legislative History of Federal Income Tax Laws, 1938-1861, pp. 992, 995 (1938). Senator Sterling felt quite strongly that the bill was too generous. Hence he proposed that it be "qualified by some expression as 'losses incurred in legitimate and ordinary trade pursued by the party,' or equivalent words." 50 Cong. Rec. 3849 (1913). Senator Williams, a ranking member of the Finance Committee who was in charge of the income tax provisions of the bill, vigorously apposed the proposal:

"Mr. Williams. Mr. President, the object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.' Ibid.

Thereafter the following discussion took place:

"THE SECRETARY. On page 169, line 15, it is proposed to strike out the words 'in trade' and insert 'by the taxpayer in the pursuit of any ordinary and legitimate trade or business."

"MR. STERLING. If the amendment were adopted,

the provision would read:

"Losses incurred by the taxpayer in the pursuit of any ordinary and legitimate trade or business.

"Mn. WILLIAMS. In other words, you are going to count the man as having money which he has not got,

⁷ Though Senator Sterling's amendment dealt with "losses," the discussion which followed disclosed a controlling philosophy which encompassed all deductions for business outlays, whether technically "losses" or "expenses."

⁸ See Blakey, The Federal Income Tax, p. 87 (1940); Ratner, American Taxation, p. 330 (1942).

because he has lost it in a way that you do not approve of.

"Mr. STERLING. And I think rightly so.

"Mr. Smoot. Mr. President, I should like to ask the Senator what becomes of the man who is a broker and whose whole business is dealing upon the stock exchange! Does the Senator think that he ought to be taxed upon his income; and, if so, should not that man be allowed to deduct whatever loss he may incur in that particular line of business!

"Mr. Sterling. I think so, because Lithink the business of the broker, as a general proposition, is a legitimate business; but the amendment would exclude losses sustained in stock and grain gambling; that is

the idea.

"Mr. Smoot. The senator differentiates, then, between the broker who does nothing else but follow that business and the man who does it 'on the side'?

"Mr. Sterling. Oh, no. A han may occasionally engage in the brokerage business, and, taking a particular deal, it may be perfectly honest and legitimate; or he may be a regular broker engaged continuously in a business which is legitimate. My only object in suggesting this amendment is to prevent, if it can be done, what might be termed the setting off of a loss in a strictly gambling operation.

"MR. McCumber. Let me ask the Senator a question right there. If the successful party in the gambling operation—and I always supposed that what one man loses the other man gains in a straight gambling contract—makes \$10,000, would not the Senator charge it

up to him as taxable income?

"Mr. Sterling. I do not know but that I would; and I do not think there would be any injustice or wrong

in doing so.

"Mr. McCumber. Very well. Then, if the Senator taxes him once upon that, why should he seek to tax that same \$10,000 twice, both to the man who lost it and to the man who gained it?

"Mr. Sterling. The same supposition might be made in other cases, so far as that is concerned. You do not

always avoid double taxation.

"The amendment was rejected." Id. at 3850.

Despite his defeat Senator Sterling tried once more:

O "THE SECRETARY. The Senator from South Dakota [Mr. Sterling] * * now proposes the following amendment: On page 169, line 15, insert the word 'lawful' after the word 'in' and before the word 'trade,' so as to read:

"Incurred in lawful trade or arising from fires,

storms, or shipwreck, etc.

"Me Sterling. Mr. President, I simply wish to say that this amendment is in form somewhat different to the one I offered in Committee of the Whole. That amendment referred to losses that might be sustained in legitimate or ordinary trade. I hardly think those were the apt and exact words to be used in this connection, but the word 'lawful' is better. It is the purpose of the amendment simply to prevent a claim for losses or a deduction of losses arising out of a trade or a business carried on in violation of law.

"The amendment to the amendment was rejected."

Id. at 4613.

In view of this revealing legislative discussion, the Court of Appeals clearly erred in disallowing the deduction of the payments made to the loctors. To borrow the words of Sentor Williams, the respondent has rejected the deduction because the outlays were made "in a way" which the respondent did "not approve of." Although the sole "object" of Section 23(a)(1)(A) "is to tax a man's net income"— "his actual profit during the year"— the respondent has assumed that the provision was designed "to reform mon's moral characters." As a result the respondent has naturally imposed a tax on far more than "net income," which consists of "receipts" less "expenditures." And

⁹ Senators McCumber and Smoot were both members of the Finance Committee, and later each became Chairman of the Committee.

¹⁰ See pp. 11-12, supra.

in taxing much more than "net income" or "actual profit," the respondent has necessarily penalized the petitioners because of business outlays which were easily "ordinary" and "necessary." At the same time, as Senator McCumber remarked, the respondent has zealously taxed the same sum "twice, both to the man who lost it and to the man who gained it."

Indeed, in approving the respondent's strange views on "net income," the Court of Appeals tacitly conceded that the payments to the physicians satisfied the requirements of Section 23(a)(1)(A). Otherwise the Court would not have invoked the so-called doctrine of public policy. Certainly the concession was clearly required unless the opinions of this Court were to be ignored.

This Court has held that an outlay is a business expense if it "is directly connected with" or "proximately resulted from" the taxpayer's business. Kornhauser v. United States, 276 U.S. 145, 153 (1928). See further Trust of Bingham v. Commissioner, 325 U.S. 365, 373-374 (1945). This Court has also declared that an expense is "ordinary" if it is "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," or "embraced within the normal overhead or operating costs" of the enterprise. An "extremely relevant" consideration "is the nature and scope of the particular business out of which the expense in question accrued." Deputy v. du-Pont, supra, at 495-496. Or as previously stated in Welch v. Helvering, 290 U.S. 111 (1933), in determining what is ordinary, "we have recourse to any fund of business experience, to any known business practice." "The standard set up by the statute is not a rule of law; it is rather a way of life." Hence our guide is "the ways of conduct and the forms of speech prevailing in the business world." Id. at

²¹ The Tax Court put the matter quite bluntly. The payments, it declared, "are not deductible cordinary and necessary expenses because the contracts under which these payments were made violated public policy." (R. 196.)

114, 115. Finally, this Court has held that an expense is "necessary" if it is "appropriate and helpful" in the conduct of the business concerned. Id. at 113. See also Commissioner v. Heininger, supra; at 471. Cf. Commissioner v. o Flowers, 326 U. S. 465, 470 (1946).

Obviously, the sums paid by the petitioners were "directly connected" with their business. The payments were. intimately related not only to the business, but to the production of income for the business. Cf. Trust of Bingham v. Commissioner, supra, at 373-374. They were certainly "ordinary," since they were "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," and included in "the normal overhead or operating costs" of the business. In making the payments the petitioners simply conformed to "the ways of conduct" of the "particular business" in which they were engaged. And the payments easily qualified as "necessary." 12 In fact, they were more than merely "appropriate and helpful." The payments were unavoidable if the pettioners were to compete successfully in an industry where the custom of making payments was firmly entrenched through no choice of their own. In short, the amounts paid to the physicians fell well within Section . 23(a)(1)(A).

B. As this Court succinctly observed in Commissioner v. Heininger, supra, at 473, the so-called doctrine of public policy has "narrowed the generally accepted meaning of the language used in § 23(a)." The doctrine is admittedly "a judicial gloss" (Jerry Rossman Corporation v. Commissioner, 175 F. 2d 711, 713 (C. A. 2, 1949)); for "neither the tax statute nor the treasury regulations condition deductibility upon the lawful character, either directly or remotely, of the expenditures made." National Brass Works

¹² As regards the "necessity" of a business expense, this Court has stated that "we should be slow to override" the taxpayer's "judgment." See Welch v. Helvering, supra, at 113.

v. Commissioner, 182 F. 2d 526, 530 (C. A. 9, 1950).13 Under "the broad definition of gross income, income arising from an illegal business is taxed even though the illegality be one declared by the Constitution itself The provisions of the statute fixing the deductions to be regarded in arriving at the net income which alone is taxed ... are as broad and unqualified as those defining the taxable gross income." Alexandria Gravel Co. v. Commissioner, 95 F. 2d 615, 616 (C. A. 5, 1938). See also Minton, J., Heininger v. Commissioner, 133 F. 2d 567, 569 (C. A. 7, 1943). Apart from its disregard of the statute, the doctrine of public. policy is one of those curious principles which are more easily invoked than justified. Though the doctrine has, of course, been rationalized from time to time, the reasons have not improved with age. Indeed, age has disclosed increasing blemishes.

Generally speaking, the doctrine has been applied in three areas. In the first place, penalties incurred in the course of business have been disallowed as deductions. See, e.g., Great Northern Railway Co. v. Commissioner, 40 F. 2d 372 (C. A. 8, 1930), cert. denied, 282 U. S. 855 (1930); Burroughs Building Material Co. v. Commissioner, 47 F. 2d 178 (C. A. 2, 1931); Chicago, Rock Island & Pacific Railway Co. v. Commissioner; 47 F. 2d 990 (C. A.7, 1931), cert. denied, 284 U. S. 618 (1931); Commissioner v. Longhorn Portland Cement Co., 148 F. 2d 276 (C. A. 5, 1945), cert. denied, 326 U. S. 728 (1945). But cf. Huff, Andrews & Thomas, 1 B. T. A. 542 (1925). Secondly, legal expenses have been similarly disallowed where they were incurred in contesting the imposition of a penalty or other public sanction and the defense was unsuccessful. See, e.g., Burroughs Building Material Co. v. Commissioner, supra; National Outdoor Advertising Bureau v. Helvering, 89 F. 2d 878

of any regulation in which the respondent has sought to define the statutory words "ordinary" and "necessary." See Commissioner v. Heininger, supra, at 470.

(C. A. 2, 1937); Helvering v. Superior Wines & Liquors, 134 F. 2d 373 (C. A. 8, 1943). Thirdly, political bribes and commercial extortions have also been disallowed. See, e.g., Rugel v. Commissioner, 127 F. 2d 393 (C. A. 8, 1942); Kelley-Dempsey & Co., 31 B. T. A. 351 (1934); T. G. Nicholson, 38 B. T. A. 190 (1938). But cf. Alexandria Gravel Co. v. Commissioner, supra, where no undue influence was found, which was cited approvingly in Heininger v. Commissioner, supra, at 569.

Since the decisions on "public policy" have wandered well beyond the statute, the courts have not found it easy to explain the reasons for the results. Undoubtedly "the judicial function in construing legislation is not a mechanical process from which judgment is excluded." But it is equally true that the judicial function is "very different from the legislative function." "To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another." Addison v. Holly Hill Co., 322 U. S. 607, 617-618 (1944). This admonition is especially appropriate here. For in seeking to apply a doctrine of public policy in the realm of business expenses the courts have simply called upon "some unexpressed spirit" far removed from the language and policy of Section 23(a)(1)(A). Under the circumstances the opinions are unavoidably unsatisfactory. And the difficulties which nourish their inadequacies "can neither be met nor avoided by spurious interpretation of tax provisions dealing with allowable deductions." McDonald v. Commissioner, supra, at 63. .

Three decisions sufficiently illustrate a few of the inescapable difficulties. In Great Northern Railway Co. v. Commissioner, supra, the taxpayer sought to deduct penalties which had been assessed for violations of the Safety Ap-

¹⁴ In Commissioner v. Heininger, supra, this Court granted certiorari because of an alleged conflict with the decisions in the National Outdoor and the Superior Wines cases. See 320 U.S. at 470.

pliances Act15 and the Hours of Service Law.16 The Eighth Circuit agreed that the expenses "arose in connection with the operation of the road." But, the Court concluded, it 'cannot be" that Congress intended to reduce the penalties by means of a tax deduction. 40 F. 2d at 373. In Burroughs Building Material Co. v. Commissioner, supra, the taxpayer had paid a state fine after pleading guilty to an indictment for price fixing. The Second Circuit disallowed the deduction of the fine. The Court reasoned that the fine had no "necessary" connection with the business and refused. to sanction expenditures of such a character as we have here on grounds of public policy." 47 F. 2d at 180. Later the Second Circuit reappraised the doctrine of public policy in National Outdoor Advertising Bureau v. Helvering, supra, which involved legal expenses incurred. in an anti-trust proceeding. In denying the deduction of the expenses the Second Circuit justified the doctrine on the ground that it "is never necessary to violate the law in managing a business." 89 F. 2d at 881.

The varying explanations which appear in these cases hardly survive analysis. For example, to argue that a penalty is "unnecessary" is to ignore the context in which Section 23(a)(1)(A) functions. In our increasingly complex society, swarming with rules and regulations, legal differences with the Government have become an ordinary, everyday hazard of doing business. It has become the business of businessmen to find their way, as best they can, , through "the daedalian mazes" of statutes, decisions, directives, instructions and forms. Cf. Jerry Rossman Corporation v. Commissioner, supra, at 714. Amid the flourishing "thickets of verbiage" words frequently dance before the eye "in a meaningless procession," leaving "only a confused sense of some vitally important, but successfully concealed, purport." Hand, Thomas Walter Swan, 57 Yale L. J. 167, 169 (1947). Violations are inevitable though in-

^{15 36} Stat. 299 (1910), 45 U. S. S. A. § 13.

^{16 39} Stat. 722 (1916), 45 U.S. C. A. § 66.

tentions are the most honorable. Errors in good faith are to be expected and expectations are repeatedly justified. If judges, administrators and lawyers so often disagree, laymen should scarcely do better. To put the matter in a nutshell, "there are 'penalties" and 'penalties." "Jerry Rossman Corporation v. Commissioner, supra, at 713. While not all are practically unavoidable, a good many unfortunately are. And so even courts which have disallowed the deduction of penalties have abandoned a wootlen rule which would bar the deduction in all cases. They have come to realize that penalties incurred in good faith in the ordinary course of business represent the normal cost of doing business. See Jerry Rossman Corporation v. Commissioner, Supra (alternative ground for decision); National Brass Works v. Commissioner, supra. Cf. I. T. 3530, C. B. 1942-1, p. 43.

If penalties for wrongdoing are "unnecessary," so are outlays caused by torts. Nevertheless the courts have repeatedly held that a taxpayer may deduct damages paid to a private person because of a wrong committed in the operation of a business. They have considered it immaterial whether the injury was caused by negligence, conspiracy, misrepresentation, conversion, or violation of a statute. See Becker Bros. v. United States, 7 F. 2d 3 (C. A. 2, 1925) -infringements of patent; Helvering v. Hampton, 79 F. 2d 358 (C. A. 9, 1935) -fraud; Anderson v. Commissioner, 81, F. 2d 457 (C. A. 10, 1936)—negligence resulting in death; H. M. Howard; 22 B. T. A. 375 (1931)-misrepresentation and conspiracy; W. R. Hervey, 25 B. T. A. 1282 (1932)-violation of usury laws; International Shoe Co., 38 B. T. A. 81 (1938)—conspiracy; Robert S. Farrell, 44 B. T. A. 238 (1941)—unlawful acts as director; William Ziegler, Jr., 5 T. C. 150 (1945)—mismanagement of corporation; Dixon Fagerberg; 1942 P.-H. B. T. A. Memo. Dec. ¶ 42,091—conversion of corporate assets.17 In Helvering v. Hampton, supra, at 360, the Court of Appeals for the

¹⁷ See further O. D. 978, C. B. 5, p. 135 (1921); I. T. 3627, C. B. 1043, p. 111; I. T. 3762, C. B. 1945, p. 95.

Ninth Circuit stated, "We cannot agree that private wrong-doing in the course of business is extraordinary within the meaning of the taxing statute allowing deductions for ordinary and necessary expenses. The statute itself makes no such exception . . . "18 See also Anderson v. Commissioner, supra, at 460. If "private wrongdoing" in business is not "extraordinary," we fail to understand why "public wrongdoing" always is. "

The decisions relating to private wrongs are relevant in another connection. As indicated, the argument has been made that the deduction of a penalty would, in effect, "reduce" or "mitigate" the sanction. But the deduction of damages imposed because of a private transgression similarly "reduces" or "mitigates" the sanction imposed upon a taxpayer for his wrongful conduct. It is not surprising that on other occasions the respondent has disparaged any distinction between penalties and damages, and has contended that both are equally non-deductible. See, e.g., Helvering'v. Hampton, supra, at 359; International Shoe Co., supra, at 95. In both cases "public policy" is equally involved and equally violated.

The Second Circuit has frankly confessed that unless "an arbitrary line" is drawn, it is difficult to reconcile the decisions which allow the deduction of outlays deriving from a "private" wrong with the decisions which deny the deduction of outlays deriving from a "public" wrong. Burroughs Building Material Co. v. Commissioner, supra, at 180. After pointing out that fines may be "not infrequent" and "inevitable," the Court stated, "It is not easy to distinguish such fines from expenditures incurred in connection with actions to recover for negligence or because of

¹⁸ In the Heininger case this Court seems to have approved the Hampton decision. See 320 U. S. at 472; n. 6. Cf. Kornhauser v. United States. supra; Fass v. Commissioner, 75 F. 2d 326 (C. A. 1, 1935); Isaav P. Keeler, 23 B. T. A. 467 (1931); William A. Falls, 7 T. C. 66 (1946). But cf. National Outdoor Advertising Bureau v. Helvering, supra, at 881.

patent infringements, unless one draws an arbitrary line between criminal and civil actions even where the criminal actions relate to matters involving no moral turpitude. Undoubtedly expenditures which are in themselves immoral, such as for bribery of public officials to secure protection of an unlawful business would not have to be allowed in order consistently to justify a deduction of fines paid for violations of law involving no moral turpitude and practically inevitable." See further Note, 54 Harv. L. Rev. 852, 856 (1941).

Even if a doctrine of public policy might in some cases properly apply where a federal statute has been violated, the doctrine is surely an "alien intruder" where state statutes and other indicia of local policy are involved. As this Court has "often had occasion to point out, the revenue

¹⁹ The Court evidently felt that such payments as bribery of public officials do for qualify as outlays "ordinarily" made, quite apart from any extra-statutory concept of public policy, and that the disallowance of such expenses could well be placed on that statutory ground. See also Alexandria Gravel Co. v. Commissioner, supra, at 616; Excelsior Baking Co. v. United States, 82 F. Supp. 423, 428 (D. Minn. 1949); Kelley-Dempsey & Co., supra, at 354; and 4 Mertens, The Law of Federal Income Taxation, § 25.35 (1142). The term "ordinary" is not free from ambiguity at the outer edges. Hence the Treasury may apparently define "ordinary" in a particular area of expenditure by a reasonable exercise of its rule-making power. For example, in Textile Mills Corp. v. Commissioner, 314 U. S. 326 (1941), this Court sustained a regulation which excluded lobbying expenses from the concept of "ordinary and necessary." The regulation is probably extreme in a number of cases, since there are industries where legislative activity is quite "ordinary." How ver, though in various instances "the factual situation will be so extreme as to leave no doubt," this Court recognized that "the nuances of facts between the two extremes have produced a nebulous field of confusion which has been recognized by courts striving to fit close cases into one category or the other." And "interpretative regulations" are "appropriate aids toward eliminating that confusion and uncertainty." See Magruder v. Realty Corp., 316 U. S. 69, 73-74 (1942), referring to the Textile Mills decision.

laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application." United States v. Pelzer, 312 U. S. 399, 402 (1941). "Were it not so, federal tax legislation would be the victim of conflicting state decisions on matters relating to local concerns and quite unrelated to the single uniform purpose of federal taxation." Estate of Rogers. v. Commissioner, 320 U.S. 410, 414 (1943). We need hardly add that "the single uniform purpose" of Section 23(a)(1(A) is not directed toward the enforcement of "the peculiarities and special incidences" of local policies. Cf. Lyeth v. Hoey, 305 U.S. 188, 193 (1938). That purpose, rather, contemplates a tax on business income after allowance for all business expenses which are "ordinary" and "necessary" according to the ways of conduct and the forms of speech prevailing in the business world." Commissioner v. Heininger, supra, at 472.

The respondent's understanding of Section 23(a)(1)(A) simply disregards its clear purport and plain function. This provision "was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the State infliets." Nor was this provision contrived to enforce canons of business behavior or professional ethics as they may variously evolve in the state courts. Certainly there is no indication that the respondent's agents are particularly skilled in the art of regulating trade practices as uistinguished from the art of computing and collecting taxes.

In so far as Section 23(a)(1)(A) is concerned, the basic policy of Congress is well beyond the pale of doubt. The sole objective of Section 23(a)(1)(A) is to confine the burden of the income tax to net income. "The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it dis-

²⁰ Member Sternbagen, dissenting in Burroughs Building Material Co., 18 B. T.A. 101, 105 (1929).

torts the liability of the particular taxpayer to the detriment or advantage of the entire tax paying group." Higgins, v. Smith, 308 U. S. 473, 477 (1940). The respondent's reliance on some notion of public policy, above and beyond Section 23(a)(1)(A), is mere question begging. To borrow Mr. Justice Holmes' memorable phrase, the public policy of taxation is not "a brooding omnipresence in the sky" (Southern Pacific Co. v. Jensen, 244 U. S. 205, 222 (1917)) whose aid the respondent may periodically invoke as he sees fit. The public policy of taxation is the policy which Congress creates, and that policy is expressed in the taxing provisions which Congress has enacted.

C. The respondent apparently assumes that in Commissioner v. Heininger, supra, this Court approved some extra-statutory principle of public policy forbidding the deduction of outlays which are otherwise well within the language of Section 23(a)(1)(A). Evidently the respondent is more confident in this regard than the Second Circuit. See Jerry Rossman Corporation v. Commissioner, supra, at 713. In the Heininger case this Court observed that "The Bireau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the lan-s guage used in Section 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct." 320 U. S. at 473. In making this observation, the Court hardly endorsed by indirection any vague doctrine of public policy as a criterion of deductibility for tax purposes. The Court merely indicated, we believe, that even the nebulous notion of public policy, which lower courts had at times approved, did not bar the particular deduction in controversy. See id. at 475.

There are several indications in the *Heininger* opinion, that this Court was dissatisfied with the doctrine of public policy. To begin with, the opinion pointedly noted that the doctrine "narrowed the generally accepted meaning of the

language used in Section 23(a)." In the same connection the opinion explicitly stated that "the language of Section 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible." And the opinion then declared that the tax laws do not "penalize illegal business by taxing gross instead of net income." Id. at 474. Clearly this statement rejects any vagrant principle of public policy. For under any such theory illegal business should not be allowed any deductions on the ground that deductions aid and encourage taxpayers to engage in unlawful activities. Cf. Minton, J., in Heininger v. Commissioner, supra, at 570.21 Moreover, if the Heininger decision approved the doctrine of public policy, it did so by disapproving a very substantial portion of that doctrine. Previously it had been held that a taxpayer could not deduct legal expenses incurred in an unsuccessful effort to forestall a penalty or other public sanction. See Jerry Rossman Corporation v. Commissioner, supra, at 713; and cases cited at pp. 16-17, supra. As a result of the Heininger opinion the Treasury has finally abandoned this view. See, e.g., G. C. M. 24377, C. B. 1944, p. 93; G. C. M. 24810, C. B. 1946, p. 55.

The petitioners' payments to the physicians were plainly deductible under the *Heininger* decision. As the *Heininger* opinion indicates, the denial of the deduction would render the petitioners taxable on "gross instead of net income;" and a tax on gross income would necessarily "penalize" the petitioners, although Section 23(a)(1)(A) was not designed to punish taxpayers. In summarizing the scope of the *Heininger* decision as it applies here, we cannot do

a neat distinction between "legitimate" and "illegitimate" expenses. All are equally dedicated to the successful operation of the illegal enterprise. But cf. G. A. Comeaux, 10 T. C. 201, 207 (1948), aff'd, 176 F. 2d 394 (C. A. 10, 1949), which states that the "distinction may at first seem nebulous," but "is nonetheless real."

better than quote from Judge Minton's opinion in the same case for the Court of Appeals for the Seventh Circuit: "If the deduction in the case at bar was not an ordinary and necessary expense to the 'carrying on' of the business, we are unable to understand the English language. Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary." Heininger v. Commissioner, supra, at 570.

D. Even if the meaning of Section 23(a)(1)(A) is mysteriously hedged by some doctrine of public policy, the Court of Appeals erred in denying the deduction of the pay-

ments to the physicians.

In Commissioner v. Heininger, supra, the taxpayer was a dentist who made and sold false teeth in a mail order business. The Postmaster General issued a fraud order against him on the ground that his statements tended to mislead prospective customers or to misrepresent the quality of his product. The taxpayer sought an injunction against the fraud order, but his efforts ultimately failed. During the litigation he incurred lawyer's fees and related legal costs, which he later deducted in computing his federal income taxes. As in the present case, the Commissioner strenuously argued that Section 23(a)(1)(A) does not sanction any deduction which contravenes public policy. This Court rejected the argument for reasons which equally apply here and which the Court of Appeals misunderstood.

If the outlays "are to be denied deduction," the Court stated, "it must be because allowance of the deduction would frustrate the sharply defined policies" of the postal statutes "which authorize the Postmaster General to issue fraud orders. The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators; such punishment is pro-

vided by separate statute, and can be imposed only in a judicial proceeding in which the accused has the benefit of constitutional and statutory safeguards appropriate to trial for a crime." Hence it followed "that to allow the deduction" of the expenses "would not frustrate the policy of these statutes; and to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding." Id. at 474-475.

The reasoning of this Court in the Heininger case peculiarly applies here. No federal or state statute imposed any "personal punishment" on the petitioners because of their payments to physicians. For that matter the petitioners, unlike the taxpayer in the Heininger case, were not subject to any statute or rule of law designed to deter them from the questioned business practice. The payments had not the remotest stigma of illegality. In denying the deduction the Court of Appeals neceszarily attached "a serious punitive consequence" upon the petitioners where none was otherwise imposed upon them. The Tax Court has candidly conceded that "the effect" of its decision in this case "was to penalize the optician." See Weather-Seal Manufacturing Co., 16 T. C. No. 158 (1951).

²² The opinion further stated that the postal statutes were not designed to deter alleged offenders from employing counsel in defense against fraud orders.

proval by legislation imposing penalties. See California Business and Professional Code (Deering, 1949 Pocket Supp.) §§ 650, 652; Remington's Revised Statutes of Washington, Annetated (1949-Supp.) § 10185-14. This year North Carolina also imposed a penalty for the first time. See General Statutes of North Carolina (Supp. 1951) § 90-255.

²⁴ Cf. I. T. 1853, C. B. II-2, pp. 124, 125 (1923), which, in allowing a deduction, distinguished between an "illegal transaction"— "something falling within the prohibition of positive enactment"—and a breach of egatable duty.

The Court of Appeals reasoned that the agreements between the petitioners and the physicians were contrary to public oolicy because the rebates violated the fiduciary responsibility of the physicians to their patients. The alleged violation consisted of the doctor's "secret profits through dealings with his patients." (R. 228.)25 If we extend the utmost credit to this reasoning, the Court of Appeals merely established that the agreements were contrary to public policy in the sense that a physician would not be able to recover upon them. Cf. Reilly v. Beekman, 24 F. 2d 791 (C. A. 2, 1928), on which the Court of Appeals refled. The rule of law implicit in the physician's inability to recover is exclusively directed against the physician and is solely designed to prevent him from collecting the promised payment. The rule does not even attempt "to impose personal punishment" on the physician. On no theory would the doctor's inability to enforce payment be deemed a penalty for an unlawful act. At worst the physician would be deprived of a profit to which he was not entitled. See. Jerry Rossman Corporation v. Commissioner, supra, at 712. In disallowing the deduction of the payments, the Court of Appeals affirmatively punished the petitioners by virtue of a rule of private law which is not at all aimed at them and does not purport to punish anyone else. In short, the petitioners have been punished because the doctors allegedly misbehaved.

In Jerry Rossman Corporation v. Commissioner, supra, the Court of Appeals for the Second Circuit held that under the Heininger decision fines and forfeitures are deductible, depending "upon the place of sanctions in the scheme of enforcement of the underlying act." The Court expressly rejected any rigid rule that a taxpayer may not deduct payments resulting from a violation of statute or

²⁵ There is no question of tax avoidance here. The physicians regularly reported the petitioners' payments as taxable income. (R. 28, 40, 59-60, 76, 137, 143, 148, 153-154, 159.) The respondent is attempting to tax the same amounts as income to the petitioners.

some other manifestation of policy. 175 F. 2d at 713. Instead the Court held that a penalty is deductible as long as the allowance does not "frustrate" any "sharply defined policies" of the act imposing the penalty. In this case, unlike the Rossman case, no "sanction" whatever was imposed upon the petitioners which the deduction could conceivably frustrate. In fact, the petitioners were not even subject to the slightest "scheme of enforcement."

The decision of the Court of Appeals in this case nicely exemplifies the endless confusion which the principle of "public policy" inevitably breeds.26 The Court of Appeals did not deny that the questioned payments, apart from publie policy, qualified as ordinary and necessary business expenses. However, the Court concluded that the payments were not deductible because they failed to satisfy the standards of equity as compared with the standards of the market place. In support the Court quoted Mr. Justice Cardozo's famous admonition that many "forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Meinhard v. Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546 (1928). This quotation leaves no doubt of the Court of Appeals' confusion. The present controversy is not a suit

The Treasury is by no means immune to the confusion. See, for example, its vacillating views on the deductibility of truckers' fines, as reflected in P.-H. 1950 Fed. Tax Serv., ¶ 76,321, and I. T. \$1042, C.B. 1951-1, p. 15. And see the twists and turns related in G. C. M. 23438, C. B. 1942-2, p. 188. Nor have the courts been free from confusion. As instances, compare the Tax Court's views with those of the Fifth Circuit in Longhorn Portland Cement Co., 3 T. C. 310 (1944), rev'd in part, 148 F. 2d 276 (C.A. 5, 1945); and the Tax Court's views with those of the Eighth Circuit in Helvering v. Superior Wines & Liquors, 134 F. 2d 373 (C. A. 8, 1943), rev'g 1941 P.-H. B. T. A. Memo. Dec. ¶ 41,364. See further the varying attitudes in Greene Motor Co., supra.

in equity, nor was Section 23(a) (1) (A) devised as a means of enforcing the sensitive standards of equity. That provision simply authorizes deductions from gross income in accordance with "the ways of conduct" in "the business world." Welch v. Helvering, supra, at 115; Commissioner v. Heininger, supra, at 471. In its anxiety to apply a principle of equity, wholly unrelated to federal taxation, the Court of Appeals overlooked the language and policy of Section 23(a)(1)(A).27 Just as the allowance of deductions under that provision does not depend upon "equitable considerations" (Deputy v. du Pont, supra, at 493), neither does their denial.28

In an effort to sustain as conclusion, the respondent has sought to envelop the petitioners in an atmosphere of evil and corruption which he apparently attributes to them. As the petitioners have stated and as the record clearly re-

²⁷ Cf. Burnet v. Guggenheim, 288 U. S. 280, 289 (1933): "A transfer within the meaning of a taxing act may or may not be one within the statute of Elizabeth,"

²⁸ The Court of Appeals' opinion additionally indicates that "public policy" easily leads into a quagmire of abstract assumptions divorced from relevant fact. The opinion argued that the agreements between the petitioners and the physicians were unenforceable because they tended to corrupt the latter into prescribing unnecessary or unduly expensive glasses, recommending an inferior optician, and artificially increasing the price of glasses. However, the record provides no evidentiary basis for this conclusion. It is a speculation rather than a finding. Cf. F. L. Bateman, 34 B. T. A. 351, 367 (1936), where, in analogous circumstances, the Board of Tax Appeals refused to assume corruption in the absence of evidence to that effect. Again, the practice of payments to physicians no more corrupted them than the other custom whereby they lawfully purchase glasses at a wholesale price and resell ' them at a retail price. Nor is the physician who receives a payment from an optician more tempted to do what the Court of Appeals feared than the physician who runs his own optical business and therefore has a potential financial stake in prescribing glasses. All these considerations sharply underscore the futility of using Section 23(a)(1)(A) as a means of policing the integrity of eye doctors.

veals,²⁹ payments to doctors reflected a settled industry practice when the petitioners entered the optical field.³⁰ To suggest that the petitioners initiated a policy of corrupting physicians is to indulge in naive imaginaton. In 1941 the Chairman of the Section on Ophthalmology of the American Medical Association frankly declared that doctors were generally oblivious to any professional standards on the subject. The standards were "more 'honor'd in the breach than in the observance." Needless to say, the petitioners would have been very glad to retain the sums paid to the doctors if competitive conditions had permitted them to do so.³²

The various medical resolutions and editorials quoted by the respondent graphically indicate that the custom of

²⁰ See pp. 3-4, supra.

³⁰ The respondent has not denied that the evidence to this effect is clear and uncontradicted. Instead he has resorted to the frail excuse that the evidence consists of "statements, often self-serving, of various witnesses." (Resp. Brief In Opposition to Pet. for Certiorari, p. 15.) The evidence in question was direct oral testimony subject to the usual safeguards provided by cross examination.

²¹ Snell, Some Principles of Medical Ethics Applied to the Practice of Ophthalmology, 117 The Journal of the American Medical Association, 497, 498, (1941).

The respondent has pointed out that a competitor of the petitioners discontinued the same practice after the taxable years in question. (Resp. Brief in Opposition to Pet. for Certiorari, p. 8.) This competitor was the American Optical Company, which, the Government charged in 1946, was paying rebates to about 3,000 physicians. (R. 165, 172.) A survey in 1940 showed that since "the optician depends completely on the good favor of the eye physician, he must take pants to avoid irritating either the physician or his patients." In Chicago alone it was estimated that "90 to 99 per cent of all eye physicians" not only accept payment, but that most have shrewd ways of seeing that they get it." What Don You Pay For Eyeglasses? 22 Fortune 103 (Oct. 1940), cited below by the respondent. (Brief and Appendices, for the Resp., p. 32, n. 14.)

making payments to physicians was a widespread business practice. In 1946 the Department of Justice was "informed that the rebating practice is industry wide." The Department metlcalously supplied details which embraced Chicago, Dallas, Oklahoma City, Minneapolis, and Denver. In a number of instances the amounts taken by the physicians exceeded the sums retained by the opticians. The Department stated that "some individual physicians receive as much as \$40,000 annually in rebates." "Moreover, the actual cumulative figures indicate that one group of physicians in Iowa received more than \$42,000. One physician in a small town in Texas received almost \$15,000, a sum equaled by physicians in Minneapolis, Waterloo, Iowa, Rockford, Ill., and other small communities." Since the practice was so widespread, there were several resolutions on the subject in the American Medical Association. Nor has the physicians' practice of taking rebates been carefully, confined to eye-glasses. Doctors have similarly engaged in the practice of obtaining rebates from pharmacists and makers of braces and splints. . "The development of roentgenology as an important medical specialty and the establishment of clinical pathologic laboratories to which physicians send patients for the making of highly technical and often costly tests have introduced new sources of rebates, kickbacks and commissions." (Resp. Brief in Opposition to Pet. for Certiorari, pp. 21-26.)

E. The issue before the Court spreads far beyond this immediate case. It extends into every nook and cranny of business life which is increasingly controlled and supervised by government. Each public regulation reflects a "public policy," and any outlay due to a deviation from that "policy" is necessarily involved in the principle which the respondent seeks to apply. Nor does the reach of this principle pause at the shifting borders of public regulation. As the Court of Appeals' decision vividly illustrates, the principle cuts deep into the whole complex of private rela-

tions between businessmen. No limitation is in sight,²³ for a principle of so called "public police," is conveniently free from any restrictions which a rule of tax law normally implies.³⁴ "The meaning of the phrase 'public policy' is vague and variable; there are no fixed rules by which to determine what it is." Steele v. Drummond, 275 U. S. 199, 205 (1927).³⁵ See also Twin City Co. v. Harding Glass Co., 283 U. S. 353, 356 (1931). Since the respondent is invoking some extra-statutory principle which is "unconfined and vagrant" (cf. Schechter Corp. v. United States, 295 U. S. 495, 551 (1935) a there are no discernible restraints upon the powers of censorship which he would eagerly assume in the process of collecting taxes.³⁵⁰

The Tax Court's opinion in this case illustrates that public policy is essentially indefinable unless vague generalities are considered a definition. The Tax Court defined public policy as "the public good. Everything that tends clearly to undermine that sense of security of individual rights, whether of personal liberty or private property, which any citizen ought to feel, is against public policy." Next the Tax Court redefined public policy as "the community common sense and common conscience extended and applied throughout the state to matters of public morals, public

³⁸ Even where legal theories are relatively restrained, they have, "in an odd kind of way, the faculty of self-generating extension." Texas v. Florida, 306 U. S. 398, 434 (1939).

^{4&}lt;sup>34</sup> Compare I. T. 3724, C. B. 1945, p. 57, and I. T. 3811; C. B. 1946-2, p. 70, with *Leta Sullenger*, 11 T. C. 1076 (1948).

^{a5} In the same case this Court warned that the principle of public policy "must be cautiously applied to guard against confusion and injustice." See id. at 205.

carefully confined to Section 23(a) (1) (A). He has sought to deny a charitable deduction on the ground that the charity's activities violated a local penal law. However, the First Circuit frustrated the attempt, observing that the meaning "of the word 'charitable' in a federal revenue act is a matter of federal, not local, law." Faulkner v. Commissioner, 112 F. 2d 987, 992 (C. A. 1, 1940).

health, public safety, public welfare, and the like; it is that general, and well settled public opinion relating to man's plain, palpable duty to his fellow men, having due regard to all the circumstances of each particular relation and situation." Then the Court further defined public policy as prohibiting "that which has a tendency to be injurious to the public welfare." (14 T. C. at 1079-1080.). Surely in allowing, the deduction of "ordinary and necessary." business expenses Congress did not authorize the respondent to censor deductions according to his views on "security of individual rights;" "common sense and common conscience;" "public morals, public health, public safety, public welfare, and the like;" "man's plain, palpable duty to his fellow men.", Yet the decision below hardly authorizes the respondent to de less.

Certainly the respondent does not have any modest notion of the powers at his command in the name of "publie policy." We do not have to speculate in this respect. For instance, in F. L. Bateman, supra, the taxpayer, who was in the freight forwarding business, pursued "a common practice" of paying "varying amounts to employees of railroads, and also industries." The payments were required because of "the congested condition of traffic and transportation, competition, and shortage of cars," and "were of great value to the company, not only in the successful operation of its business but in the production of business, with its resultant nevenue." 34 B. T. A. at 367. Despite the obvious and intimate connection between the business and the payments, the respondent sought to disal-Now the deduction of the payments because they were "tips" designed to "create discrimination." Ibid. While the Board of Tax Appeals overruled the respondent, the case nevertheless eveals that the respondent's views of "public policy" are undisturbed by any apparent limitations.37

³⁷ Judge Arundell indicated in his dissenting opinion in the Tax Court that there is little to distinguish the present case from the Bateman case. 14 T. C. at 1088. For a similar attempt to disallow tips, see Marra Bros., Inc., 3 T. C. M. 1317 (1944).

According to the respondent, Section 23(a)(1)(A) is concerned with far more than "net income" or "actual profit." It is also concerned with "men's moral characters." See p. //, supra. The respondent frankly regards Section 23(a)(1)(A) as a special delegation of power to regulate and disapprove business practices and procedures. As this case discloses, the respondent even assumes that the vast and shadowy area of professional ethics equally falls within his alleged power of supervision. He would convert Section 23(a)(1)(A) into a federal policing provision employed to implement not only federal policies, but local policies having nothing to do with federal taxation.

A principle which is unconfined and elusive in content is inevitably harsh and retroactive in application.38 Again this case serves as a grim illustration—and the illustration speaks for the entire industry. For many years opticians, sincluding the pe ioners, excluded theorebates from their taxable net income and the respondent's agents repeatedly approved the exclusion. Since the rebates were a substantial portion of the opticians' gross receipts, the exclusion was necessarily a vital factor in business assumptions, calculations and risks. In the present case the rebates of the City Optical Company for 1942, 1943 and 1944 aggregated \$178,687.05 (R. 179), as compared to a total book value of only \$76,191.32 as of December 31, 1942. (14 T. C. at 1068.) Again, for 1943 and 1944 the rebates of the two Companies . varied between 61-per cent and 72 per cent of their taxable income as adjusted by the respondent.39 Despite its longcontinued administrative practice and without any prior warning of a change in position, the Treasury has now reversed itself in the name of public policy and imposed actax on what is plainly gross income. Disastrous financial consequences are inescapable under the retroactive impact of

³⁸ We need not remind this Court of the evils of retronctivity in income taxation. See, e.g., Helvering v. Goiffiths, 318 U.S. 371, 402-403 (1943); Claridge Apartments Co. v. Commissioner, 323 U.S. 141, 164 (1944).

³⁰ See pp. 4-5, supra.

the principle pursued by the respondent. Surely in enacting Section 23(a)(1)(A) Congress did not contemplate "so deadly a remedy" which no word in that statute implies or suggests. Cf. Bruce's Juices, Inc. v. American Can Co., 330 U. S. 743, 754 (1947). Yet so "deadly a remedy" is unavoidable if the respondent may pass upon the social desirability of business outlays and eviace his displeasure by taxing gross income.

The vast implications and consequences of the decision below were acutely anticipated in a penetrating appraisal

of the respondent's public policy doctrine:

"Once the courts attempt to deter undesirable business activity through the disallowance of various busi-. ness expenditures, they must face a series of increasing. ly indefinite factual situations. The simplest is where the expenditure may be considered the penalty of a previous adjudication of unlawful conduct: these are the fines, judgments, and legal expenses. The Courts have said that public policy requires this method of deter-Tence only where there has been a prosecution by the government. The second situation is where either the actual expenditure or the activity in which it was incurred is in violation of law; here the expenditure is habitually disallowed. The third factual situation differs from the second in that while the activity is not in violation of law, nevertheless it is considered contrary to the best public interest.

"In the first two situations, the sources of policy are confined to the criminal and regulatory statutes. Its application is limited to the general deterrence of violations of criminal statutes, and, in regulatory statutes, where there has been a previous adjudication of violations. In the third situation, the source's of public policy are not thus restricted; presumably these sources may be any expression, whether of judicial or legislative origin, of which activities are inimical to the public interest. The only limitations would appear to be two inarticulately expressed judicial standards: the ideal

business man and the public welfare.

"The rule in the first two situations may perhaps be justified by a principle of statutory construction that

the word 'lawful' may be read before a word of 'allinclusive import'-in this case, before the word 'expense.' But even this principle is unavailing in the third situation, and justification of disallowances on grounds of effectuating public policy must overcome both the contrary import of the statutory language and the countervailing policy against the judicial conversion of a tax on net income into a possibly exorbitant tax on gross receipts. In addition, the extension of the concept of illegality arising from criminal and regulatory statutes to the concept of effectuation of public policy involves the acceptance en masse of all the artificiality such a vague standard must necessarily contain. The negligible relation of such a standard to the determination of what the tax burden of an individual taxpayer should be indicates that even though the restricted concept of illegality be retained, the broad concept of effectuating public policy should be discarded. To do so will, of course, result in the loss of haphazard additions to the national revenue. But increases in revenue should come either from an extension of tax liability or from an increase in rates, rather than from the distortion of a relatively rational system of taxation." Note, 54 Harv. L. Rev. 852, 858-860 (1941).

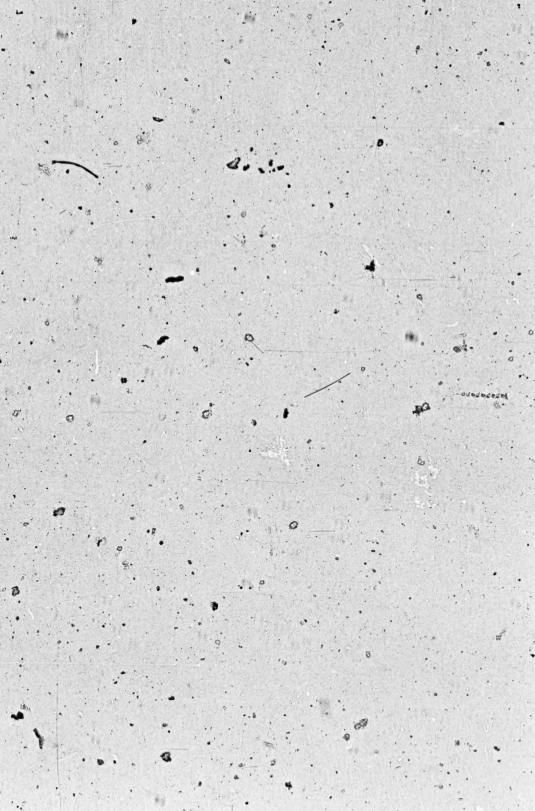
CONCLUSION.

As the language of Section 23(a)(1)(A) readily reveals, that provision specifies its own criteria of deductibility. The expense must be a "business" expense; it must be "ordinary;" and it must be "necessary." The statute provides no less and no more. In applying criteria which are nowhere to be found in the statute, the Court of Appeals has seriously erred. The decision of the Court of Appeals should accordingly be reversed.

Respectfully submitted,

RANDOLPH E. PAUL, Counsel for the Petitioners.

HENRY LEHRICH, Louis Eisenstein, Of Counsel.



SUPREME COURT, U.S.

P1LED DEC 1. 1951

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

No. 158.

THOMAS B. LILLY and HELEN W. LILLY, Petitioners,

COMMISSIONER OF INTERNAL RE INCE, Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

REPLY BRIEF FOR THE PETITIONERS.

RANDOLPH E. PARD, Counsel for the Petitioners.

HENBY LEHRICH, LOUIS EISENSTEIN, Of Counsel.

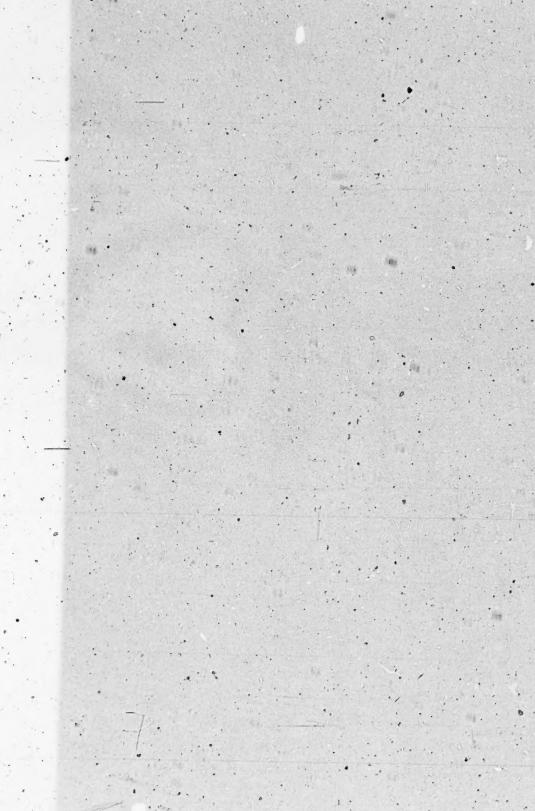


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REPLY BRIEF FOR THE PETITIONERS.

The respondent's brief, we believe, has nicely confirmed the basic inadequacies of his position. In view of these inadequacies he anxiously urges an affirmance of the Tax Court's decision on a theory which he failed to disclose or intimate in that Court. (Resp. Br. 46.) For the convenience of the Court we would like briefly to note some of the deficiencies in the respondent's contentions.

1. The respondent's opening premise is that he who seeks a deduction must show a "clear provision therefor." (Resp. Br. 13.) We do not disagree with this statement of principle. However, the respondent's invocation of the principle has a peculiarly strange ring in this case. For it

is the respondent who has steadfastly ignored a "clear provision" of the Internal Revenue Code in order to apply a canon of deductibility emanating from beyond the Code. If one does not end with the words of a statute, "one certainly begins there." Federal Trade Commission v. Bunte Bros., 312 U.S. 349, 350 (1941). Even tax law is no exception to this customary procedure in reading and applying statutes.

2. Although the respondent dwells at some length on the so-called doctrine of public policy, he fails to indicate the relevance of that doctrine in applying a statute which was simply designed to tax "commercial net income." "In law also the right answer usually depends on putting the right question." Estate of Rogers v. Commissioner, 320 U. S. 410, 413 (1943). Since the respondent has avoided "the right question," he has consistently assumed that Section 23(a)(1)(A) is a sanction directed against certain business expenses which are delusively defined in terms of "public" policy." As a result, he spends a good deal of time or considerations which might be quite significant in a suit in equity, but are quite irrelevant in the calculation of an income tax. Cf. Helvering v. Hallock, 309 U. S. 106, 118 (1940); Helvering v. Clifford, 309 U.S. 331, 334 (1940). We are afraid that the respondent misses the essence of the matter. Section 23(a)(1)(A) implements and executes the fundamental principle of ability to pay by confining the tax to receipts less "ordinary and necessary" expenses. It makes no attempt to punish taxpayers by suspending the principle of ability to pay when the respondent feels that "public policy" may have been flouted. The statute hardly operates "in a vacuum," as the respondent pessimistically suggests (Resp. Br. 16), if it serves its own vital function and leaves other problems to other statutes.

Indeed, by ignoring the purpose of Section 23(a)(1)(A) the respondent has inevitably imposed a penalty rather than a tax. He has seen fit to punish the petitioners not

only "by taxing gross instead of net income" (cf. Commissioner v. Heininger, 320 U. S. 467, 474 (f943)), but by asserting a tax liability which far exceeds their net earnings. Specifically, for 1944 the respondent has imposed an aggregate tax of \$49,577.88 with respect to a net profit of \$25,280.06. (R. 3, 5, 199-200; Computation of Tax under Rule 50 in Tax Court.) Surely, in imposing a tax on "net income," Congress did not contemplate such bizarre and cruel consequences nor a tax rate which approaches 200 percent of earnings. Even a fraud penalty does not exceed 50 percent of a tax deficiency. Internal Revenue Code \$293(b).

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3. The respondent scarcely explains away the illuminating legislative history of 1913. (Resp. Br. 25.) That history emphasizes that in allowing deductions for "expenditures or losses" Congress was not concerned with approving or disapproving business outlays on moral grounds. The respondent weakly suggests that in failing to legislate Congress necessarily adopted some principle of public policy as variously applied in the lower courts.²

As this Court wisely observed in Scripps-Howard Radio. v. Commission, 316 U. S. 4 (1942), "The search for significance in the silence of Congress is too often the pursuit of a mirage. We must be wary against interpolating our

In this connection the respondent states that an "expense," as distinguished from a "loss," must be "ordinary" and "necessary." We do not understand how this distinction helps the respondent in ignoring the legislative history or in applying a principle of public policy to expenses which are otherwise "ordinary" and "necessary."

² The respondent seems to say that a full-fledged doctrine of public policy has been judicially established for thirty-eight years. The first appellate decision recognizing an isolated aspect of the doctrine did not appear before 1930. Great Northern Railway Co. v. Commissioner, 40 F. 2d 372 (C. A. 8, 1930), cert, denied, 282 U. S. 855 (1930). Since then the doctrine has had a tortuous career in the courts. See Pet. for Cert. p. 14 et seq.; Pet. Br. p. 15 et seq. And in Commissioner v. Heininger, supra, this Court disapproved a good deal of the public policy doctrine as understood by the respondent. Pet. Br. p. 24.

notions of policy in the interstices of legislative provisions." Id. at p. 11. "To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities." And. "we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle." Helvering v. Hallock, supra, at pp. 119-121.3 In regard to its own decisions this Court has stated, "It would require very persuasive circumstances enveloping Congressional silence to debar this Court from reexamining its own doctrines." 309 U. S. at p. 119. Certainly this Court is at least equally free to appraise a disorderly doctrine which has sporadically evolved in the lower courts—especially if the doctrine has been insensitive to Congressional policy and is inevitably creating a quagmire of confusion. Cf. Higgins v. Smith, 308 U. S. 473, 478 (1940); Neirbo Co. v. Betklehem Corp., 308 U.S. 165, 174 (1939). In the words of Judge Learned

⁸ See further United States v. Underwriters Assn., 322 U. S. 533, 559 (1944); Girouard v. United States, 328 U. S. 61, 69 (1946); and concurring opinion of Rutledge, J., in Cleveland v. United States, 329 U. S. 14, 21 (1946).

⁴ As the respondent has pointed out, Congress acted in 1934 within the restricted area of wagering losses by disallowing such losses to the extent that they exceeded wagering gains. Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 23 (g). The same rule is now incorporated in Section 23(h) of the Internal Revenue Code. When Congress enacted the provision, it had been held that losses in illegal gambling transactions were deductible only to the extent of gains in similarly illegal transactions. At the same time losses from legal gambling transactions were fully deductible. ever, it appeared that "many taxpayers" would "take deductions for gambling losses but fail to report their gains." Hence Congress limited the deduction of losses in order to "force taxpayers to report their gambling gains if they desire to deduct their gambling losses." . H. R. Rep. No. 704, 73d Cong., 2d Sess. (1934) 22; Sen. Rep. No. 558, 73d Cong., 2d Sess. (1934) 25. In brief, the 1934 amendment merely sought to limit the deduction of all gambling losses as a means of preventing a specific kind of tax evasion. The objective of the provision was not to penalize gambling, but to safeguard the integrity of the tax system.

Hand, "To suppose that Congress must particularly correct each mistaken construction under penalty of incorporating it into the fabric of the statute appears to us unwarranted; our fiscal legislation is detailed and specific enough already." F. W. Woolworth Co. v. United States, 91 F. 2d 973, 976 (C. A. 2, 1937), cert. denied, 302 U. S. 768 (1938).

4. The respondent makes the astonishing assertion that an expense is not "ordinary" unless "it conforms to the standards of the business community as a whole" rather than the norms of the particular trade. (Resp. Br. 57.) This Court has articulated a somewhat different view. The basic criterion of "ordinary" is "normalcy in the particular business." See Deputy v. du Pont, 308 U. S. 488, 495-496 (1940). See also 4 Mertens, The Law of Federal Income Taxation, p. 317 (1942). As Mertens felicitously puts it, "The test may well be said to be what the average hardheaded businessman would have done under like circumstances." Id. at p. 319.

The respondent makes a related statement which is similarly surprising. He insists that payments to physicians were not ordinarily made in the industry. (Resp. Br. 56.) Since this matter was discussed in our original brief (p. 29 et seq.), we consider it inappropriate to explore anew the same ground. We would like to note, however, that in 1946 the Government publicly declared that the practice was "industry wide." (M. at p. 31.) Apparently for the purposes of this case the Government prefers to suggest that the facts were otherwise.

5. The respondent apparently misunderstands the petitioners' position. According to the respondent, the petitioners are supposedly arguing that "Section 23(a)(1)(A) is concerned solely with net income, so that any denial of deduction for an expense actually paid or incurred contravenes the statute." (Resp. Br. 23.) On the basis of this misapprehension the respondent then replies that the al-

leged argument "ignores the fact that Congress did not authorize deduction of every business expense paid or incurred, but only of such expenses paid or incurred as were 'ordinary and necessary.'" Ibid. The respondent has methodically answered an argument which the petitioners have not made. The petitioners readily agree that an expense must be both "ordinary and necessary" in order to be deductible. Since the outlays involved in this case qualified as "ordinary and necessary," the petitioners contend that the respondent has erred.

- 6. The respondent arges this Court to "pay great deference to the expert judgment of the Tax Court." (Resp. Br. 14-15.) Of course, as the respondent is undoubtedly well aware, his own "deference" is quite flexible. It varies from case to case, depending on whether the Tax Court happens to agree with him. For a few recent examples, see Crane v. Commissioner, 331 U.S. 1 (1947): Commissioner v. Estate of Church, 335 U.S. 632 (1949); Commissioner v. Korell, 339 U.S. 619 (1950). At present we need not dwell, at length upon the respondent's elastic notions of "deference" as they are regularly reflected in the cases. The Tax Court's conclusion in this case did not derive from an "expert judgment" representing an accretion of technical tax wisdom. See Trust of Bingham v. Commissioner, 325 U.S. 365 (1945). Moreover, here as in Commissioner v. Heininger, supra, at pp. 470, 475, the Tax Court "denied the claimed deduction not by an independent exercise of judgment but upon a mistaken conviction that denial was required as a matter of law," It did not act "upon its own interpretation of the words 'ordinary and necessary,' " but under the supposed compulsion of an appellate decision. (R. 180.)
 - 7. The respondent argues rather emphatically that the payments to the doctors artificially raised the retail price of glasses by one-half of what the price would otherwise be. (Resp. Br. 48.) There is no evidence in the case to

sustain this conclusion. Obviously a price structure is. determined by much more than one isolated cost factor. However, even if we indulge in the respondent's gratuitous assumption, we fail to understand the significance of his argument. The purpose of Section 23(a)(1)(A) is not to control or limit prices. 'Moreover, if the respondent's factual assumption is correct, in the absence of payments to physicians, the customers would have paid a price which was one-third less than the price actually paid. Therefore, the petitioners would have had a net profit equal to their actual net profit in this case. Yet their tax would have accordingly been less than the tax now asserted by the respondent, though their profit would have been precisely the same. Or to state the matter differently, the respondent is, in effect, adding a penalty, because the petitioners made payments to the physicians.

8. In his effort to sustain his conclusion the respondent is compelled to indulge in exaggeration. For example, he cites the Restatement on Restitution for the proposition that under "established rules of contract, agency and trust, the patients could have recovered the rebates" from the petitioners. (Resp. Br.) There is nothing in respondent's reference which ratifies his view that a customer could have recovered from the petitioners any related amount which they had already paid to the physicians. In that context the petitioners would not be unjustly enriched, nor would they be withholding a "benefit" which should be restored to the "beneficiary." On the other hand, if we assume that a customer were able to recover the same amount from the petitioners before it was paid to the physician, the amount of the recovery would be clearly deductible as a business

Section 138 of the Restatement on Restitution states that a "third person who has colluded with a fiduciary in committing a breach of duty, and who obtained a benefit therefrom, is under a duty of restitution to the beneficiary."

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expense, as even the respondent seems to concede. (Pet. Br. 19-20; Resp.-Br. 55.)

- 9. The respondent is not disinclined to mention irrelevancies. To illustrate, he mentions two criminal statutes which have nothing to do with this case. To quote the respondent, these statutes provide that "the giving of consideration to an agent with intent to influence his action in relation to his principal's business constitutes a misdemeanor." (Resp. Br. 35.) These two statutes have no bearing here and must have been imported into the case solely for atmospheric purposes. Obviously a physician is not the agent of his patient, and a patient does not engage in business by purchasing glasses.
 - 10. The respondent misconstrues this Court's decision in Textile Mills Corp. v. Commissioner, 314 U. S. 326 (1941). He erroneously assumes that the decision embraced the vagrant doctrine of public policy which he espouses. In that case the Court considered the validity of a regulation which denied the deduction of any sums "expended for lobbying purposes." See id. at p. 337, n. 16. The regulation made no mention of public policy and did not distinguish between legitimate lobbying contracts and the illegiti-

From a tax standpoint it seems odd to say, as the respondent in effect argues, that petitioners could have deducted any amounts paid back to their customers, but may not deduct any amounts paid to the doctors, from whom the customers could have recovered. In both cases the seller's gain on the sale is exactly the same.

The evidence in no way supports the respondent's assertion that the petitioners "camouflaged" their payments to the doctors. The payments were clearly classified as "trade discounts" on the petitioners' books and tax returns, and the petitioners made no attempts to conceal the "discounts" and payments. (R. 21, 22, 121-123, 161-175.) The doctors were clearly identified on the petitioners' books, and the payments made to them were unmistakably shown. (R. 21, 88, 90, 94, 96-97, 101-102, 104, 117, 118, 121, 164-175.) The Tax Court conceded "that the petitioners reasonably believed that the deduction was proper in computing income," and that "there was no concealment as to the amount of the deduction." 14 T. C. at 1086.

mate variety. It determined rather that lobbying expenses, regardless of their nature, are not ordinarily and necessarily incurred in the conduct of a business. But cf. Mc-Garry v. Limerick Gas Committee, [1932] Ir. R. 135, allowing the deduction of lobbying costs as business expenses.

In sustaining the regulation the Court stated that the "words 'ordinary and necessary' are not so clear and unambiguous in their meaning and application as to leave no room for an interpretative regulation." The Court then pointed out that the Treasury, in the exercise of its "rulemaking authority," might reasonably determine that expenses of lobbying are not "ordinary and necessary," whether or not the expenses in a particular case are incurred under a fully enforceable contract. Therefore, the Court considered it wholly immaterial whether the precise arrangement involved in the case "would violate the rule" which outlaws certain lobbying contracts: See Textile Mills Corp. v. Commissioner, supra, at pp. 338,639. See further Sanset Scavenger Co. W. Commissioner, 84 F. 2d 453 (C. A. 9, 1936), where the Ninth Circuit similarly sustained the regulation as a not unreasonable interpretation of Rordis nary and necessary," though the Tax Court considered the expenses involved as entirely "legitimate."

In this case, as in the Heininger case, "we do not have the benefit of an interpretative departmental regulation defining the application of the words 'ordinary and necessary' to the particular expenses here involved." See 320 U.S. at p. 470. See further Pet. Br. 21, n. 19. For that matter, here the Treasury has made no attempt whatsoever to define what is "ordinary" and "necessary" in the light of "common or frequent occurrence in the type of business involved." See Deputy v. du Pont, supra, at p. 495. Instead the respondent has ignored the concepts of "ordi-

^{*}Lobbying expenses are susceptible to a more generalized treatment, for by and large there are no serious industry variations in practice.

nary" and "necessary" in order to deny a deduction on the basis of public policy. Needless to say, the respondent is not an expert in the realm of public policy nor is his conclusion here based on any expert knowledge of tax law. This Court has indicated that even regulations are not particularly authoritative where they "do not embody the results of any specialized departmental knowledge or experience." Haggar Co. v. Helvering, 308 U. S. 389, 398 (1940). This appraisal of the Treasury's administrative wisdom is a fortiori applicable here, for not even a regulation is involved and the respondent has stepped much beyond his limited area of "superior knowledge." Estate of Sanford v. Commissioner, 308 U. S. 39, 53 (1939).

11. In order to sustain the asserted deficiencies the respondent resorts to a theory which admittedly "was not urged in the Tax Court." On appeal the respondent devoted two pages to this new theory, which the Court of Appeals considered too trivial to mention. The respondent's new theory, as we understand it, is that the payments in question are not deductible because they constituted violations of the Sherman Act. (Resp. Br. 46.) In support of this position the respondent refers to a complaint in an anti-trust suit and a consent judgment to which neither petitioner was a party.

As the respondent himself evidently concedes, the decision of a lower court may not be sustained on a new legal theory where "facts not already of second are required for decision." (Resp. Br. 49, n. 20.) It is "familiar appellate procedure" that if the correctness of a lower court's deci-

⁹ Resp. Br. 49, n. 20.

¹⁰ Resp. Br. in Ct. of App. 35-36. This was not the first time that a new theory appeared in the case for the benefit of the respondent. In the Tax Court he did "not argue" that the payments "were contrary to public pollby." Instead he argued that the payments were "not ordinary and necessary expenses in that they were voluntary and incident to an unethical practice." (R. 199.)

sion hinges on a determination of fact which only that court "could make but which has not been made," the appellate court cannot take the place of the trial court. See Securities Commission v. Chenery Corp., 318 U. S. 80, 88 (1943). This Court explained in Hormel v. Helvering, 312 U. S. 552, 556 (1941), that "our procedural scheme contemplates that parties shall come to issue in the trial forum vested with authority to determine questions of fact. This is essential in order that parties may have the opportunity to offer all the evidence they believe relevant to the issues which the trial tribunal is alone competent to decide; it is equally essential in order that litigants may not be surprised on appeal by final decision there of issues upon which they have had no opportunity to introduce evidence."

There is not the slightest evidence in this case that the petitioners violated the anti-trust laws in making payments to physicians. As the respondent's argument indicates, the anti-trust laws are directed against conspiracies to fix prices. They are not concerned with rebates unless the rebates are an integral element in a plan to fix prices. This view is plainly reflected by the complaint against the American Optical Company upon which the respondent now strangely relies. The gravamen of this complaint was that the American Optical Company and certain doctors, not these petitioners, had entered into a conspiracy to fix the price of spectacles.

See also Bondholders Committee v. Commissioner, 315 U. S.
 189, 192 (1942); LeTulle v. Scofield, 308 U. S. 415, 421 (1940);
 General Utilities Co. v. Helvering, 296 U. S. 200, 206 (1935);
 Anderson v. Commissioner, 156 F: 2d 591, 593 (C. A. 2, 1946);
 Legg's Estate v. Commissioner, 114 F. 2d 760, 766 (C. A. 4, 1940).
 12 In the Hormel case itself a new theory was considered on

¹² In the Hormel case itself a new theory was considered on review because of "exceptional circumstances"—an intervening decision by this Court. However, even in those unusual circumstances this Court remanded the case to the trial court in order to permit new evidence to be introduced on the new issue:

The complaint alleged that American Optical was one of the two largest manufacturers and wholesalers of ophthalmic goods in the United States. In addition, American Optical was itself engaged in the retailing of spectacles to the public. The Government charged that American Optical had conspired with a number of physicians to sell glasses to patients at a price which would be "at least as high as the local prevailing consumer prices charged by optometrists and retail opticians for spectacles" of "equivalent quality." American Optical sought to preserve this price level, the Government declared, in order "to maintain the good will of optometrists and retail opticians" who were its customers as well as its competitors in the retail area. As a part of the plan to maintain prices at the desired level and to obtain the cooperation of the doctors to this end,13 American Optical allegedly agreed to pay physicians a portion of the retail price if they referred patients to the Company. (R. 202-220.)

We are wholly unable to understand the relevance of the American Optical complaint in this case. In the first place, the petitioners were not parties to the suit. Secondly, the complaint was directed against price-fixing and not rebates as such. Thirdly, there is absolutely no evidence in this case that the petitioners made any attempt to fix competitive prices or that their payments to doctors were directed toward this end. The competitive situation of the petitioners was utterly dissimilar to the position of American Optical. The petitioners could not have fixed prices even if they had wished to do so. They were, in fact, the victims of American Optical's activities. For that Company was

by refusing to sell to the patient of any doctor who passed on to his patient any part of the rebate, thus indirectly reducing the price to the patient. (R. 212, 214.) There is no suggestion in this record that these petitioners followed any such policy.

the petitioners principal competitor (R. 17, 74, 77, 111, 125, 129, 134-135, 146, 150, 152-153, 157) and was finally enjoined from making rebates on May 16, 1951. (Resp. Br. 83-92.)

American Optical was a giant concern in the industry. Unlike the petitioners, it carried on a tremendous trade with opticians and optometrists as well as consumers. (R. 208-209.) The Company had 254 wholesaling branches in 47 states, the District of Columbia and Hawaii. (R. 207.) It allegedly made payments to as many as 3,000 doctors. (R. 204-205.) In 1944 and 1945 its aggregate payments. to only 22 doctors amounted to \$277,676.38. (R. 221.) American Optical usually paid doctors one-half of the consumer price. (R. 210, 212-217.) However, payments varied, and representative transactions included a payment of \$11.50 where the consumer price was \$14. (R. 219.) While it may have been in the interest of American Optical to fix prices because of its peculiar relation to competitors, it is gratuitous to suggest that the petitioners violated the anti-trust laws because American Optical may have done so. We should also add that the attempt to attribute to one person the alleged guilt of another, without the least semblance of a trial, is a substantial innovation in prevailing concepts of due process.14

12. In our prior brief (p. 31 et seq.) we stated that the respondent's notion of public policy is unembarrassed by noticeable limitations. Nothing in the respondent's brief

Leven one who is charged with an anti-trust violation can be punished "only in a judicial proceeding in which the accused has the benefit of constitutional and statutory safeguards appropriate to trial for a crime." Cf. Commissioner v. Heininger, supra, at p. 474. In fact, here, as distinguished from the Heininger case, the respondent would attach "a serious punitive consequence" to his own administrative finding in a field far beyond taxation. Although both petitioners testified in this case (R. 7, 82), the respondent made no inquiry concerning an alleged violation of the anti-trust statutes, nor did he seek any information on the petitioners' connection with interstate commerce.

suggests that serious limitations are in sight. The respondent assures the Court that he possesses an "informed discretion" which enables him to discriminate wisely in supervising "every form of commercial practice" on an ad hoc basis. (Resp. Br. 53.) One need not be very imaginative in suggesting how that "informed discretion" would operate in the name of "public policy."

For example, "there is authority to the effect that a bargain to buy goods which to the buyer's knowledge the seller was under contract to sell to another" is contrary to public policy. Williston, The Law of Contracts, p. 4908 (Rev. ed. 1938). Therefore, the respondent would feel free to disallow the deduction of all expenses incurred in obtaining the bargain.15 "A bargain of employment which to the knowlec, of the parties violates an existing contract with another has been held invalid." Id. at p. 4910. Hence in the name of public policy the respondent would disallow the deduction of compensation paid under the later agreement. In a number of states an unlicensed foreign corporation cannot recover on its contracts, which are considered contrary to public policy. Id. at p. 5029. Evidently under the respondent's view expenses incurred by the corporation in connection with such contracts would not be deductible. Again, many state statutes, articulating a well-defined and traditional public policy, have long condemned contracts made or to be performed on Sundays. Id. at pp. 4824, 4831-4832; 6 Corbin, Contracts, p. 886 (1951). If the respondent is correct, a businessman would be deprived of a deduction for expenses incurred in the execution of such contracts.16

¹⁵ Very likely the respondent would consider himself equally free to ignore the cost of the goods in computing the purchaser's gain on a resale. Cf. I. T. 3724, C. B. 1945, p. 57.

¹⁶ Indeed, where a taxpayer is engaged in numerous interstate transactions, the Government's view requires the transactions to be identified and dated state-by-state, in order to prevent deductions against "public policy." There might be considerable difficulty in determining the applicable state law.

We have already noted (Pet. Br. 28, n. 26) that even the respondent is confused in applying his principle of public policy. For random additional examples, see Commissioner v. Heininger, supra; Jerry Rossman Corporation v. Commissioner, 175 F. 2d 711 (C. A. 2, 1949). The respondent's brief fortifies this conclusion.17 The respondent indicates that a taxpayer may not deduct any payment to an agent which is designed to influence the latter's services in behalf of his principal. (Resp. Br. 35.) At the same time, however, he evidently concedes the correctness of the decision in F. L. Bateman, 34 B. T. A. 351 (1936), where tips were paid so that the payee would favorably influence his principal. (Resp. Br. 54.) We are not implying that the Bateman case was wrongly decided. Wr are simply pointing out that the respondent easily gets lost in the obscurities of public policy.

The respondent's confusion reinforces Judge Arundell's warning that courts "should be reluctant to undertake the determination of the question of what is and what is not contrary to pub ic policy, both for the United States and for each of the 48 states, where the act condemned as against public policy is not one shown to be in violation of any law of the land. What are deductible items should be known to a taxpayer with reasonable certainty under our income tax system." (R. 199.)

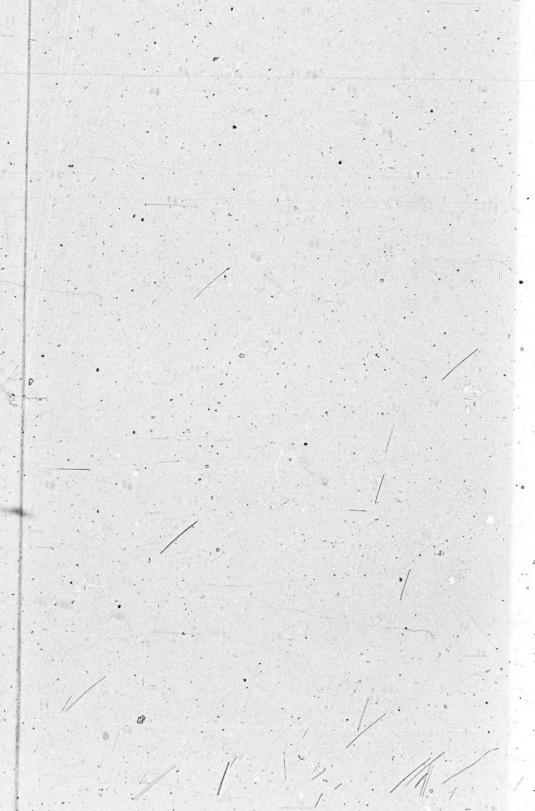
¹⁷ The respondent cites two English cases (Resp. Br. 22, n. 6), which do not tell the entire story. In those two cases deductions for penalties were disallowed because under the peculiarities of the English law they were not regarded as "in the nature of a commercial loss." The decisions did not rest on "public policy." Moreover, a basic distinction between English law and our law is that in England no deduction is allowed for damages paid because of a wrong committed in the operation of a business. Strong & Co. v. Woodifield, [1906] A. C. 448.

The respondent has unintentionally illustrated an incisive observation made many years ago by an English jurist. Public policy "is a very unruly horse, and when once you get astride it you never know where it will carry you. It may lead you from the sound law. It is never argued at all but when all other points fail." Richardson v. Mellish, 2 Bing. 229, 252 (Com. Pl. 1824).

Respectfully submitted,

RANDOLPH E. PAUL, Counsel for the Petitioners.

HENRY LEHRICH, Louis Eisenstein, Of Counsel.



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In the Supreme Court of the United States

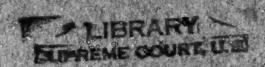
OCTOBER TERM, 1951

THOMAS B. LILLY AND HELEN W. LILLY, PETITIONERS

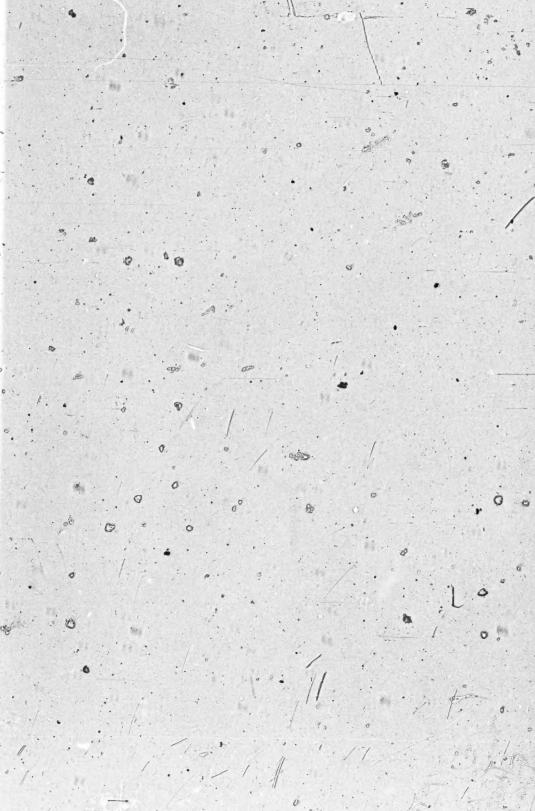
COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIFICARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION







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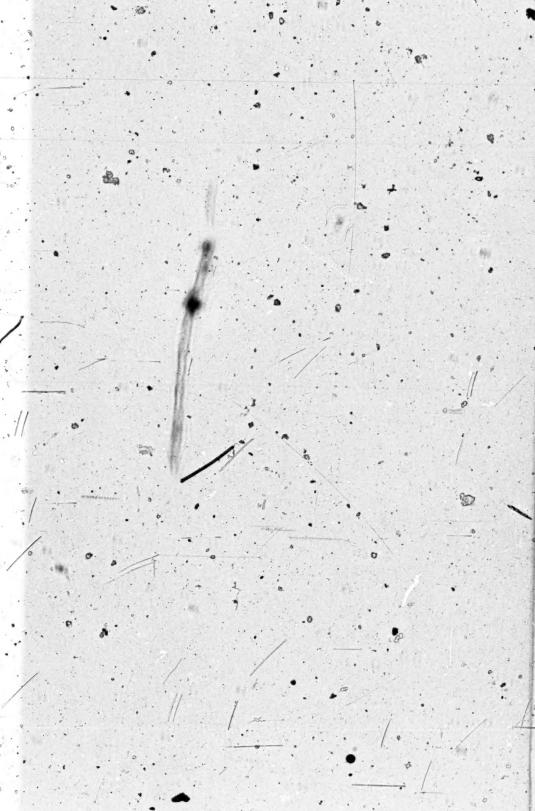
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6 Williston on Contracts (Rev. ed.), Sec. 1737, pp. 4905,
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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 158

THOMAS B. LILLY AND HELEN W. LILLY,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

0

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW .

The opinion of the Tax Court rendered en banc (R: 176-196), Judge Arundell dissenting (R. 196-199), is reported in 14 T. C. 1066. The opinion of the Court of Appeals (R. 224-229) is reported in 188 F. 2d 269.

JURISDICTION

The judgment of the Court of Appeals was entered on April 2, 1951. (R. 229-230.) The petition for a writ of certiorari was filed on June 29,

1951. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C., Section 1254.

QUESTION PRESENTED

Taxpayers, who were engaged in the business of grinding, fitting and selling eye glasses, entered into oral contracts or understandings with various physicians, whereby taxpayers agreed to pay the physicians one-third of the retail price of all glasses purchased by patients guided to them by these physicians. In practically every instance the patient was unaware of the "kickback" paid to his doctor.

The question presented is whether the Tax Court and the court below erred in holding that these secret commissions or rebates paid to the doctors were not deductible by taxpayers under Section 23(a)(1)(A) of the Internal Revenue Code as cordinary and necessary" business expenses.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

- (a) [As amended by Sec. 121 (2) of the Revenue Act of 1942, c. 619, 56 Stat. 708.] Expenses:
 - (1) Trade or Business Expenses .--
 - (A) In general.—All the ordinary and necessary expenses paid or incurred dur-

ing the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23 (a)-1. Business Expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under section 23 (b) to 23 (z), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. * * *

STATEMENT

The Tax Court and the Court of Appeals found the facts as follows with respect to the single issue ¹ raised on appeal:

Taxpayers are husband and wife, and were during the taxable years 1943 and 1944 engaged in the optical business under the trade name of City Optical Company in Wilmington, North Carolina, with

¹ Four other issues were decided by the Tax Court in taxpayers' favor. (14 T. C. 1066-1067.) The Commissioner did not appeal from these adverse rulings.

branches in other North Carolina localities, and under the name of Richmond Optical Company in Richmond, Virginia. (R. 176-177.) Taxpayer Helen W. Lilly also conducted a similar business under the name of Duke Optical Company in Fayetteville, North Carolina. (R. 176-177, 224-225.)

The City Optical Company, in computing its net income, deducted the sum of payments in each year made to'various physicians specializing in the care and treatment of the eye. These payments were described upon its books as "trade discounts". The basis for these payments was an agreement or understanding between such physicians and the City Optical Company that each physician, after performing service for his patient and prescribing proper lenses would, if possible, guide the patient to this particular optical company for the work of grinding the glasses and furnishing and fitting frames. Under these agreements the City Optical. Company paid to the physician in each case onethird of the amount it charged his patient for the services performed by the optical company. No information was volunteered to the patient that payment was to be made by the optical company to the physician of any portion of the amount paid by him to the optical company for the service there rendered. If a patient asked whether any pora tion of his payment to the optical company would be paid over to the physician, he was told; but this

occurred very rarely. (R. 177-178, 181, 191-193, 225.)

The label "trade discounts", under which taxpayers recorded these payments in their books did not correctly describe them (R. 193), but camouflaged them (R. 229). The payments to some of the oculists were made in cash at their request. (R. 193.) So far as disclosed by the record, the contracts between taxpayers and the doctors were oral. (R. 192-193.)

Patients were usually told by the physician that when their glasses were made and fitted by the optical company to bring them back to the physician for him to check the quality and accuracy of the work done by the optical company and to see if they had been properly fitted. The work to be done by the physician on return to bim by the patient might include a re-examination of the eyes of the patient, if such was required. All of these services to be rendered later by the physician were included in the charge made the patient by the physician and, accordingly, no additional charge was made for this service, whether the patient had the prescription filled by an optical company with which the physician had a so-called "kickback" agreement or an optical company with which the physician had no such agreement. (R. 178, 182-183.)

The patient in practically every instance was unaware of the fact that his physician was receiv-

ing from the optical company a portion of his payment made to that comapny. (R. 178.)

The same agreement as to "tradediscounts" was made and carried out under similar circumstances by taxpayer Helen W. Lilly, trading as Duke Optical Company, for 1943 and 1944. (R. 179, 225.)

Explanations by various witnesses at the hearing, as tending to justify the propriety of the arrangement between taxpayers and the physicians, were found by the Tax Court not to be convincing. (R. 182.)

No basis was found for the statement by some witnesses that the optician was considered as an agent or employee of the physician. The particular optician was selected by the patient, who was free to make any selection. (R. 182.)

In some cases oculist-physicians did their own "dispensing", that is, they not only measured vision and prescribed the lenses, but sent the prescription to some optical company for the grinding and fitting of the lenses to the type of frame selected by the patient, the measurements for which had been taken by the physician. On the return to the physician of the fitted lenses, they were adjusted by the physician to the patient and a total charge was made for the entire service. In these cases the practice was for the physician to charge his patient the fee for the service rendered and the retail price for the lenses and frames furnished by the optical company. The physician was then

billed by and paid the optical company at the lower wholesale rate for the lenses and frames. (R. 179, 183.)

The Tax Court found to be without basis in fact the explanation by some witnesses that the surrender by the physician of the profit he thus would have made (if he had personally bought the lenses and frames and fitted the glasses) constituted consideration for and entitled him to receive a portion of the profit derived by the optician for that service. The employment by the patient of an optician to perform the service in question relieves the physician not only of the work of the fitting and adjusting glasses, but also of the burden of financing their manufacture and eliminates the possibility of loss to the physician through the patient's failing to pay for the glasses. (E. 183.)

Taxpayers did not contend, nor did any witness testify, that the aggregate feet of the oculist and the optician or even the cost of glasses to a patient was less or no more under the "kickback" arrangement than it would have been in its absence. The practice tended to increase that cost. The oculist knew of his contract with the optician, when each patient was examined. The patient, in practically all cases, knew nothing of the arrangement. The oculist, in a relationship of great trust and confidence with respect to the patient, was subjected to the temptation of prescribing glasses where not actually necessary, or more expensive lenses than

those really needed, and of recommending an inferior optician. The cost of glasses was artificially increased by the inclusion of the physician's commission, for which the physician afforded no consideration to the patient. (R. 191, 228.)

One of the two optical companies in Greensboro, North Carolina, a competitor of the City Optical Company, ceased its practice of paying these commissions or "kickbacks" to oculists subsequent to the taxable years and prior to the hearings of the instant proceedings. (R. 178-179, 193.)

No witness, who was asked, knew of any canon of ethics of the various medical societies or associations specifically forbidding this particular practice of oculists' accepting so-called "kickbacks" from optical companies, but the practice was frowned upon and considered unethical by the medical profession as a whole, and had been criticized and condemned at meetings of the medical associations and in their professional publications. (R. 178, 185.) The Medical Society of North Carolina—the state in which these staxpayers were chiefly engaged in business—had condemned the practice. (R. 178, 228-229.)

The Principles of Medical Ethics of the American Medical Association (1943), Chapter III, Article 1, Section 5, contains the following (R. 228):

It is unprofessional to accept rebates on prescriptions or appliances, or perquisites from attendants who aid in the care of patients. And in Chapter III, Article VI, Section 4 (R. 228):

When a patient is referred by one physician to another for consultation or for treatment, whether the physician in charge accompanies the patient or not, it is unethical to give or to receive a commission by whatever term it may be called or under any guise or pretext whatsoever.

The several state medical associations have by their canons of ethics condemned the "splitting of fees" between physicians. (R. 179.)

At least two states (California and Washington) have enacted legislation forbidding this rebate, practice. (R. 228.)

"Trade discounts" allowed oculist physicians by the City Optical Company for the three following years were (R. 179):

> 1942— \$57,063.45 ² 1943— 61,601.95 1944— 60,021.65

"Trade discounts" allowed oculist physicians by Duke Optical Company for 1943 were \$6,568.87, and for 1944 were \$4,798.35. (R. 179.)

In determining deficiencies against taxpayers, the Commissioner disallowed these trade discounts

¹² Income for 1942 is relevant by reason of its effect on computation of the 1943 tax under the forgiveness features of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, Sec. 6.

as deductions (R. 1), and upon redetermination, in an opinion rendered en banc, the Tax Court sustained the Commissioner (R. 180-196), Judge Arundell dissenting (R. 196-199). Accordingly, the Tax Court decided that there were deficiencies in income taxes due from taxpayer Thomas B. Lilly for the years 1943 and 1944 in the amounts of \$54,953.67 and \$19,301.68, respectively (R. 199-200), and in the case of taxpayer Helen W. Lilly for the years 1943 and 1944 in the amounts of \$26,685.29 and \$23,167.14, respectively (R. 200).

Upon taxpayers' appeal, the court below unanimously affirmed the decision of the Tax Court (R_{\odot} 224-229), holding that (R. 227):

We certainly will not lend the force of any opinion of this court to sanction, as an "ordinary and necessary" expense of the optician's business, the making and carrying out of such unconscionable and reprehensible contracts for secret kickbacks to a doctor.

ARGUMENT

The decision of both the court below and the Tax Court, that these secret "kickbacks" to doctors to not an "ordinary and necessary" expense of an optician's business is correct and presents no question warranting further review by this Court. The ruling below is based upon the settled construction of the words "ordinary and necessary", as em-

³ Certain uncontested amounts, not here in issue, appear also to be included in the deficiencies, as found by the Tax Court. (14 T.C. 1067.)

ployed by Congress in the governing statute authorizing deduction of trade or business expense. Internal Revenue Code, Section 23 (a)(1)(A), supra, pp. 2-3. Moreover, there is no conflict of decisions requiring resolution by this Court.

1. A taxpayer seeking a deduction must be able to show that he comes within the terms of an applicable statute. New Colonial Co. v. Helvering, 292 U.S. 435, 440. The courts have frequently ruled that the allowance of a deduction is a matter of legislative grace and not a matter of right, and depends upon establishment of clear legislative provision therefor. Deputy v. duPont, 308 U.S. 488, 493; White v. United States, 305 U. S. 281, 292; City Ice Delivery Co. v. United States, 176 F. 2d 341, 350 (C. A. 4th). As a corollary, taxpayers' burden in the Tax Court was not merely to overcome the presumptive correctness of the Commissioner's determination, but further to sustain the burden of persuasion, to establish the facts and their right to the alleged deduction. Welch v. Helvering, 290 U.S. 111, 115; Helvering v. Taylor, 293 U. S. 507, 514-515; Boehm v. Commissioner, 326 U. S. 287, 294, rehearing denied, 326 U. S. 811.

Noth the Treasury and the courts have in innumerable instances been called upon to define and apply the statutory words "ordinary and necessary" to a particular state of facts. Welch v. Helvering, supra, p. 116; Deputy v. duPont, supra, p. 496; Textile Mills Corp. v. Commissioner, 314 U. S. 326, 338. Ordinarily, this Court does "not enter this quagmire of particularities." McDonald v. Commissioner, 323 U. S. 57, 65; Commissioner v. Heininger, 320 U. S. 467, 475. The rule has been evolved that no deduction should be allowed as "ordinary and necessary" which frustrates defined national or state policies proscribing particular types of conduct (Commissioner v. Heininger, supra, p. 473); "in the nature of things, public policy must narrow the field of allowable deductions which rest as they do upon legislative indulgence." National Brass Works v. Commissioner, 182 F. 2d 526, 530 (C. A. 9).

The Treasury, the Tax Court, and the federal courts have repeatedly drawn a line between legitimate business expenses and those incident to contracts or practices which contravene public policy. Textile Mills Corp. v. Commissioner, supra, pp. 338-339; Commissioner v. Heininger, supra, pp. 473-474; Rugel v. Commissioner, 127 F. 2d 393, 395 (C. A. 8th); Harden M. Loan Co. v. Commissioner, 137 F. 2d 282, 284 (C. A. 10th); Cohen v. Commissioner, 176 F. 2d 394, 400-401 (C. A. 10th); Wagner v. Commissioner, 30 B.T.A. 1099; Kelley-Dempsey & Co. v. Commissioner, 31 B.T.A. 351; Anderson v. Commissioner, 35 B.T.A. 10: Easton Tractor & Equipment Co. v. Commissioner, 35 B.T.A. 189; Kyne v. Commissioner, 35 B.T.A. 202: Nicholson v. Commissioner, 38 B.T.A 190, 198-199;

Maddas v. Commissioner, 40 B.T.A. 572, 581-582, affirmed on another ground, 114 F. 2d 548 (C. A. 3d); Silberman v. Commissioner, 44 B.T.A. 600; Weather Seal Mfg. Co. v. Commissioner, 16 T. C. No. 158; Giubbini v. Commissioner, decided October 27, 1939 (1939 P-H B.T.A. Memorandum Decisions, par. 39, 471); Barlow v. Commissioner, decided May 19, 1943 (1943 P-H B.T.A. Memorandum Decisions, par. 43,237).

On the same principle, fines and penalties paid to the national or state governments are not comprehended within the meaning of "ordinary and necessary" business expenses since their allowance would, by way of a tax advantage, constitute a partial remission, thus circumventing the public policy pursuant to which the sanctions are imposed. Great Northern Ry. Co. v. Commissioner, '40 F. 2d 372 (C.A. 8th); certiorari denied, 282 U. S. 855; Burroughs Bldg. Material Co. v. Commissioner, 47 F. 2d 178 (C. A. 2d); Chi. R. I. & P. Ry. Co. v. Commissioner, 47 F. 2d 990, 991 (C. A. 7th), certiorari denied, 284 U. S. 618; Tunnel R. R. v. Commissioner, 61 F. 2d 166, 173-174 (C. A. 8th), certifrari denied, 288 U. S. 604; National Outdoor Advertising Bureau. v. Helvering, 89 F: 2d 878, 881 (C. A. 2d); Standard Oil Co. v. Commissioner, 129 F. 2d 363 (C. A. 7th); Helvering v. Superior Wines & Liquors, 134 F. 2d 373 (C.A. 8th), certiorari denied, 317, U. S. 688; Commissioner v. Longhorn Portland Cem. Co., 148

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2. That these payments were opposed to public policy was the conclusion of the Tax Court en banc (R. 196) (only one judge out of sixteen dissenting), and the unanimous judgment of the Court of Appeals (R. 228). Such a judgment this Court will not reverse "without a definite conviction of error in the conclusion" (Helvering v. Stuart, 317 U. S. 154, 163), and, indeed, this Court avoids (p. 164) "becoming a Court of first instance for the determination of the varied rules of local law prevailing in the forty-eight states."

The Court of Appeals held that "the making and carrying out of such unconscionable and reprehensible contracts for secret kickbacks to a doctor corrupt the fiduciary relationship between physicians and patient and result in a violation of the duty of loyalty" (R. 227-228). Taxpayers' assertions that such secret kickbacks were normal and appropriate in the optician's trade are totally

without support in any finding by the Tax Court or the court below, and seem to be based only on statements, often self-serving, of various witnesses. (Pet. 3-4.) The Tax Court and the court below held, however, that this "kick-back" practice was. corrupt (R. 191, 228) and neither ordinary nor necessary. For example, the Tax Court found that a competitor of taxpayers, one of the two optical companies in Greensboro, North Carolina, had ceased the practice prior to the instant hearings. (R. 178-179, 193.) The Medical Society of North Carolina—the state in which taxpayers were chiefly engaged in business-had condemned it (R. 178, 228-229); it was considered unethical by the medical profession as a whole, and criticized at . meetings of medical associations and in professional publications (R. 178, 185). The American Medical Association, in its Principles of Medical Ethics, quoted in the Statement, supra, pp. 8-9, condemns such a rebate practice (R. 228), and by resolutions and other pronouncements published in its official journal has consistently denounced this "barter and trade in the sick patient" and "these unwholesome profits in this marketing of medical care." (Appendix, infra, pp. 24, 25.)

Editorial, dated January 17, 1948, signed by the Association's officers and board of trustees, 136 Journal of the American Medical Association, 176-177, for convenience reprinted in Appendix, infra, pp. 24-28. See also editorial, dated August 3, 1946, 131 id. 1128, likewise reprinted in Appendix, infra, pp. 21-24. These editorials refer an anti-trust suit brought by the United States in the Northern Dis-

Again, petitioners' statement (Pet. 3) that "This arrangement did not increase the price which the patient would otherwise pay for the glasses" is controverted by the express Tax Court finding that (R. 191) "It is clear to us that the practice tended to increase that cost", a finding expressly upheld by the Court of Appeals (R. 228).

In at least two states, the practice has been regarded as so objectionable, both as to payer and recipient of such rebates, as to deserve criminal penalty, Remington's Revised Statutes of Washington, Annotated (1949 Suppl), Section 10185-14; California Business and Professions Code (Deering, 1949 Pocket Supp.), Sections 650, 652. While not technically commercial bribery (1 General Statutes of North Carolina (1943), Section 14-353; Virginia Code of 1942, Annotated, Section 4712), or commercial extortion,5 these secret kickbacks fall within the proscription of the same general public policy, sharply defined by a long line of judicial decisions, which forbids corruption of a fiduciary relationship by payment of a secret consideration. Mosser v. Darrow, 341 U. S. 267,

See Kelley-Dempsey & Co. v. Commissioner, 31 B.T.A. 351, supra, cited by this Court in Commissioner v. Heininger, 320 U. S. 467, 474, in. 10, supra.

trict of Hlinois against a wholesale optical company and a number of physicians, to enjoin secret rebate arrangements similar to those involved here (R. 202-221). On May 16, 1951, subsequent to the decision below, a consent decree was entered providing substantially the relief requested in the complaint.

271; Wolf v. International Reinsurance Corp., 73 F. 2d 267 (C. 2d), certiorari denied, 294 U. S. 725; Reilly v. Beekman, 24 F. 2d 791 (C. A. 2d); City of Findlay v. Pertz, 66 Fed. 427, 434 (C. A. 6th); Meinhard v. Salmon, 249 N.Y. 458, 464; 6 Williston on Contracts (Rev. ed.), Section 1737, pp. 4905, 4906-4907, fn. 10; 2 Restatement, Contracts, Section 570.

Nor does the decision below involve unfair "retroactive" action. (Pet. 17.) As the court below pointed out, the record fails to disclose that the Commissioner had been definitely apprised of this practice, and in view of the camouflage of the payments as "trade discounts" there was little to put him on notice that the claimed deductions were secret kickbacks. (R. 193, 229.) Nor can the Treasury be expected, by express regulation, to cover every form of commercial practice: (R. 229.)

In summary, in the light of the careful consideration which the special facts of the instant record have already received in the Tax Court and the Court of Appeals, the statement by this Court in the Heininger case here assumes particular relevance (320 U.S. 467, 473):

A review of the situations which have been held to belong in this category would serve no useful purpose for each case should depend upon its peculiar circumstances.

3. The decision below is not in conflict with any decision of this Court or of other Courts of Ap-

peals. Contrary to taxpayers' contention (Pet. 8-11), Commissioner v. Heininger supports the decision below (320 U.S. 467, 473-474), for to permit the deduction here, as the Tax Court noted (R. 180-181), would directly frustrate the public policy proscribing corruption of the fiduciary relationship between physician and patient and forbidding violation of the duty of loyalty. Taxpayers' acts in making the reprehensible agreements and their "greasing of palms" (R. 194). immediately effected the corruption; they are among the acts which the public policy per se pro-To allow such unconscionable secret "payoffs", under the guise of ordinary and necessary business expenses, would directly encourage the tendency to corrupt and defeat the public policy. Compare Textile Mills Corp. v. Commissioner, 314. U. S. 326, 339, supra.

Similarly, contrary to taxpayers' contention (Pet. 11), the decision below does not conflict with Jerry Rossman Corp. v. Commissioner, 175 F. 2d 711 (C. A. 2d), supra, since the present taxpayers' violation of public policy was not innocent but intentional, and allowance of the deduction would directly frustrate such policy. Taxpayers entered into the objectionable agreements and made the payments to the physicians, as the Tax Court found, because they knew that the high degree of trust and confidence existing between the doctors

and their patients would result in the patients' following the doctors' recommendation of an optician, as they did. (R. 192, 196.)

The purpose of the settled rule applied below is not punitive, contrary to taxpayers' argument (Pet. 11), but defensive, lest the Congressional favor of a tax deduction be misconstrued or misused to the public harm. Clearly, no such considerations apply to civil damages paid individuals in reparation of tortious conduct; hence, cases such as Anderson v. Commissionen, 81 F. 2d 457 (C. A. 10th), and Helvering v. Hampton, 79 F. 2d 358 (C. A. 9th), cited by taxpayers (Pet. 12), are not opposed to the decision below. There is a sharp, difference between payments which are against public policy and those which constitute restitution for damages caused by prior tortious conduct. To permit the deduction of reparation payments, as ordinary and necessary business expenses, subverts no public interest, as would deduction of the rebates here.

CONCLUSION

The decision of the court below is correct, there is no conflict of decisions, and no question warranting review is presented. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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August, 1951.

APPENDIX

EDITORIALS

131 Journal of the American Medical Association 1128 (August 3, 1946):

Indictment of Optical Firms and Ophthalmologists
Under Sherman Act

Elsewhere in this issue (page 1138) appears a condensation of two complaints filed by the United States through the Department of Justice charging o optical wholesalers and ophthalmologists with violating the Sherman Act by fixing prices on spectacles through rebating to the ophthalmologists approximately one half of the total price paid by their patients for eye-glasses. The Department of Justice adopted the unusual device of selecting certain physicians as representative of the entire class of physicians securing rebates as defendants in the suit. Attorney General Tom C. Clark said in . connection with the filing of the suits that "the department is informed that the rebating practice is industry wide and it is presently expediting its investigation of all wholesale dispensers in the optical field. If investigation discloses similar practices, additional suits will be filed as quickly as possible." The newspaper release made by the Department of Justice states that some individual physicians receive as much as \$40,000 annually in rebates. The actual figures cited in the complaint indicate instances in which a Chicago patient was charged \$14 for lenses, the optician receiving \$2.50 and the physician \$11.50; an instance in which a patient paid \$25 for lenses, the company receiving \$10.80 and the physician \$14.20. A Dallas patient

A.

paid \$21 for lenses, which was divided approximately equally between the optician and the physician, and an Oklahoma City patient paid \$22, the manufacturer receiving \$9.10 and the physician \$12.90. Similar figures are available for prescriptions filed in Madison, Wis., Minneapolis and Denver. Moreover, the actual cumulative figures indicate that one group of physicians in Iowa received more than \$42,000. One physician in a small town in Texas received almost \$15,000, a sum equaled by physicians in Minneapolis, Waterloo, Iowa, Rockford, Ill., and other small communities.

The position of the American Medical Association on this practice has been stated definitely on several occasions. In 1924 the Section on Ophthalmology of the American Medical Association adopted a resolution stating:

Résolved, That the acceptance of commissions or considerations, either directly or indirectly, from opticians and optical houses in the sale of glasses is absolutely contrary to all our standards of medical ethics and is just as reprehensible as the splitting of fees.

That resolution was not presented to the House of Delegates and was therefore an action of the section but not an action of the American Medical Association. In 1942 a resolution was presented to the House of Delegates to the effect that

it be declared unethical for the members of the American Medical Association or its component branches to refer patients to commercial organizations, Jaboratories or other physicians who advertise to the public and others than the medical profession who employ steerers or cappers or who offer to pay rebates or commissions or in any other manner violate the Principles of Medical Ethics of the American Medical Association or its component branches.

This resolution was referred to a reference committee, which brought back a revised resolution to the House of Delegates. The following revised resolution was adopted:

Resolutions on Rebates: Your reference committee has given very serious consideration to these resolutions. It is the opinion of your reference committee that the practices referred to in the resolutions are beneath the dignity of a learned profession, are basically dishonest and are a violation of the Principles of Medical Ethics. Your reference committee therefore recommends that the following substitute resolutions be adopted:

Whereas, It has been brought to the attention of the House of Delegates that the unscrupulous practice of rebates to physicians is being engaged in by various commercial organizations, laboratories, supply houses and in some professional relationships between certain physicians; and

WHEREAS, All such practices are clearly in violation of the Principles of Medical Ethics; therefore be it

Resolved, That the House of Delegates of the American Medical Association express stern disapproval of the practice by any of the members of its component societies of referring patients to commercial organizations, laboratories or other physicians who advertise to the public and others than the medical profession, who employ so-called steerers or cappers or who pay, or offer to pay, rebates or commissions in any guise whatsoever, or who in any other manner violate the Principles of Medical Ethics of the American Medical Association; and be it further

Resolved, That any member violating these resolutions be subject to such disciplinary action as is deemed advisable by the county society in which such physician holds membership; and be it further

Resolved, That the Secretary of the American Medical Association be instructed to send a copy of these resolutions to each state and county society accompanied by a letter to the secretary of each setting forth that all such unethical practices are disreputable and unscrupulous and, if not controlled, may soon besmirch the reputation of the entire medical profession.

136 Journal of the American Medical Association 176-177 (January 17, 1948):

Rebates, Kickbacks, Commissions and Medical Ethics

The pride of medicine as a profession has always been its freedom from the taint of barter and trade in the sick patient. Physicians must give their wholehearted devotion to the care of the patient; no other objective must be given precedence over

considerations of the patient's need. Nevertheless, the charge is made that some physicians have forgotten the ethical principles that prevail in the relationship between doctor and patient and have selected the surgeon willing to make the greatest division of fees rather than the one best suited to perform the operation. Ophthalmologists have sent the patient for lenses to opticians who returned a proportion of the fee rather than to the optician who rendered the highest quality of optical service. Occasionally orthopedic surgeons and others who utilize the work of the maker of brace's, splints and elastic bandages have been willing to accept commissions from such manufacturers and have designated the procurement of these accessories to the agency offering the largest commission rather than to the one most painstaking in production and most reasonable in price. From time time criticism has been leveled against pharmacists who have offered commissions to physicians on the prescriptions sent to them and to the physicians who have accepted such commissions. Wherever barter and trade have insinuated their insidious and evil spects into the practice of medicine, the quality of the service has depreciated. The morals of the physicians and the commercial agencies that deal in these unwholesome profits in this marketing of medical care have already deteriorated.

From the beginning of its entrance on the medical scene, the American Medical Association has fought this menace to the quality of medical service and to the good repute of medical practice. Resolutions have been passed by the official bodies of the Association unequivocally condemning such practices. The Judicial Council has repeatedly urged the xpulsion or other action against physicians proved to have participated in such procedures. The leaders of surgery, ophthalmology, orthopedic surgery and pharmacy have been unanimous in pointing out the extent to which such commercial considerations may break down the good repute of the specialties concerned. The American College of Surgeons adopted an oath to be taken by its fellows to the effect that they would not participate in the secret division of fees. The Principles of Ethics of the American Medical Association have declared the unethical character of such divisions—direct or indirect.

Now the development of greater complexity in medical practice and in medical relationships has introduced new factors into this problem of barter and trade. The development of roentgenology as an important medical specialty and the establishment of clinical pathologic laboratories to which physicians send patients for the making of highly technical and often costly tests have introduced new sources of rebates, kickbacks and commissions. In some communities means have been proposed for evading the condemnation of medical organizations and societies through the establishment of corporations, cooperative laboratories and roentgenologic offices of multiple ownership.

As might have been anticipated, the ultimate development was recognition by governmental agencies of the fact that the unprotected public was being exploited by such methods. The first warning and one of tremendous significance was

the indictment by the Department of Justice of two manufacturing optical agencies and of a considerable number of ophthalmologists who participated . in a plan which took hundreds of thousands of dollars from unknowing patients. A full report appeared in The Journal of the American Medical Association when the Department of Justice took this action during 1946. A popular periodical with millions of circulation has called on the medical profession to cleanse itself as it has repeatedly cleaned its own house in the past. The House of Delegates asked the Secretary of the American Medical Association to call the situation to the attention of every state and county medical society in the nation and to urge on these societies the inttiation of the necessary steps toward ridding medical practice of these parasites. The Better Business Bureaus in several large communities, notably Los Angeles, have begun a campaign of enlightenment of the public regarding the extent to which these abuses prevail in their communities; they too have called on the medical profession to take the necessary steps to stop this pernicious practice.

The housecleaning has been too long delayed. Biology has proved that any living organism that tries to maintain itself in the presence of filth invariably dies. The Board of Trustees of the American Medical Association therefore calls on leaders of the medical profession in every community in which the Association is represented to act promptly, remembering, however, the necessity for proceeding in due form by the filing of formal charges against physicians known to be participat-

ing in such methods, thus offering an opportunity for the presentation of evidence and a suitable hearing so that the innocent may not be harmed but the guilty may be properly exposed and punished.

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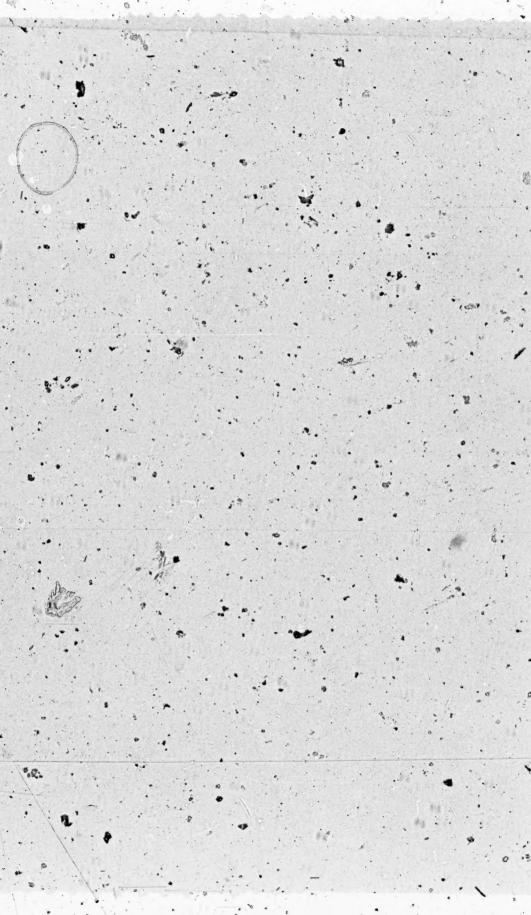
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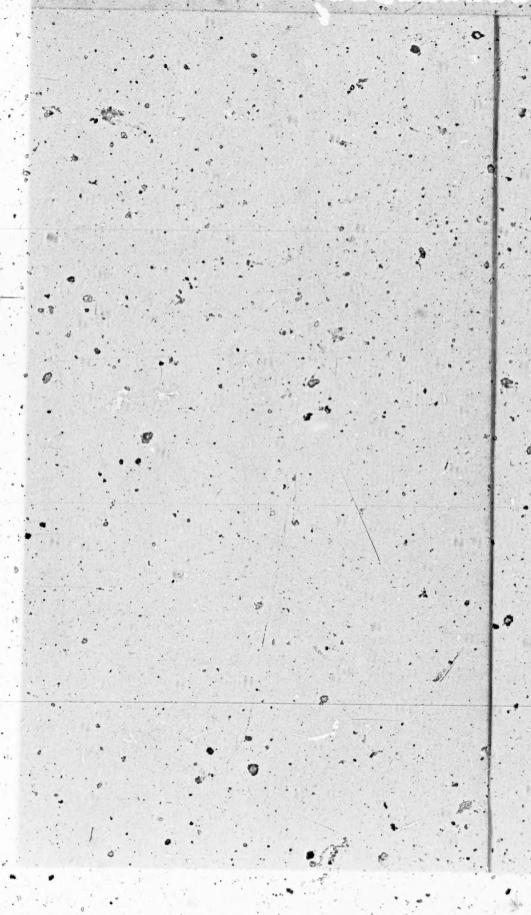
October Trans, 1951

THOMAS B. ALLY AND HELDN W. LILLY,

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIONARY TO THE UNITED STATES COURT OF APPRICE FOR THE POURTE OFFICER.

BRIEF FOR THE RESPONDENT



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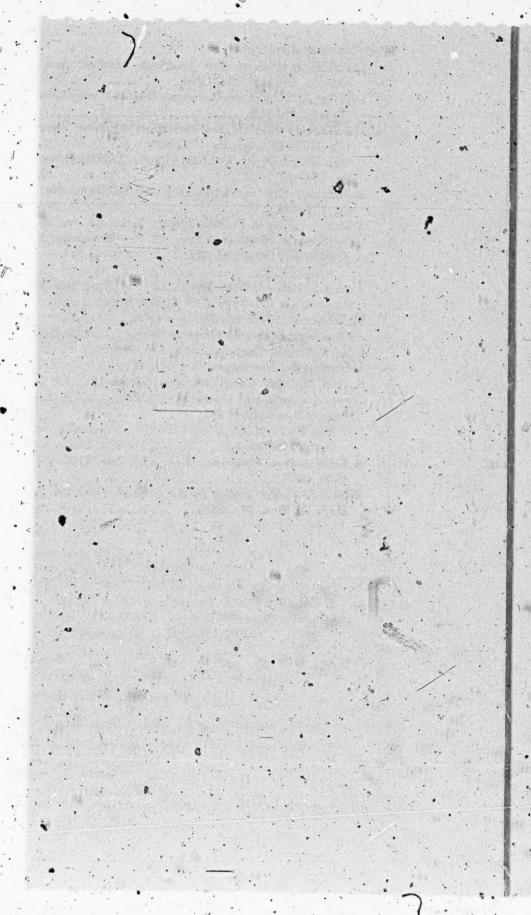
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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 158

THOMAS B. LILLY AND HELEN W. LILLY,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 142-160) is reported in 14 T. C. 1066. The opinion of the Court of Appeals (R. 183-188) is reported in 188 F. 2d 269.

JURISDICTION

The judgment of the Court of Appeals was entered on April 2, 1951. (R. 188-189.) The petition for a writ of certiorari was filed on June 29, 1951, and was granted on October 8, 1951. (R. 193.) The jurisdiction of this Court rests on 28 U. S. C., Section 1254.

8:

QUESTION PRESENTED

Taxpayers, who were engaged in the business of grinding, fitting and selling eye glasses, entered into oral contracts or understandings with various physicians, whereby taxpayers agreed to pay the physicians one-third of the retail price of all glasses purchased by patients guided to them by these physicians. In practically every instance the patient was unaware of the "kickback" paid to his doctor.

The question presented is whether the Tax Court and the court below properly held that these secret commissions or rebates paid to the doctors were not deductible by taxpayers under Section 23 (a) (1) (A) of the Internal Revenue Code as "ordinary and necessary" business expenses.

STATUTE AND REGULETIONS INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

- (a) [As amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] Expenses.
 - (1) Trade or Business Expenses.
- (A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allow-

ance for salaries or other compensation for personal services actually rendered; * * *.

(26 U. S. C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23 (a)-1. Business Expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (z), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof.

STATEMENT

The Tax Court and the Court of Appeals found the facts as follows with respect to the single issue raised on appeal:

Taxpayers are husband and wife, and were during the taxable years 1943 and 1944 engaged in the optical business under the trade name of City Optical Company in Wilmington, North Carolina, with branches in other North Carolina localities, and under the name of Richmond Op-

¹ Four other issues were decided by the Tax Court in taxpayers' favor. (14 T. C. 1066-1067). The Commissioner did not appeal from these adverse rulings.

tical Company in Richmond, Virginia. (R. 142.) Taxpayer Helen W. Lilly also conducted a similar business under the name of Duke Optical Company in Fayetteville, North Carolina. (R. 142, 184.)

The City Optical Company, in computing its net income, deducted the sum of payments in each year made to various physicians specializing in the care and treatment of the eye. These payments were described upon its books as "trade 'discounts'. The basis for these payments was an agreement or understanding between such physicians and the City Optical Company that each physician, after performing service for his patient and prescribing proper lenses would, if possible, guide the patient to this particular optical company for the work of grinding the glasses and furnishing and fitting frames. Under these agreements the City Optical Company paid to the physician in each case one-third of the amount it charged his patient for the services performed by the optical company. No information was volunteered to the patient that payment was to be made by the optical company to the physician of any portion of the amount paid by him to the optical company for the service there rendered. If a patient asked whether any portion of his payment to the optical company would be paid over to the physician, he was told; but this occurred very rarely. (R. 142-143. 146, 153-155.) In practically every instance the

patient was unaware of the fact that his physician was receiving from the optical company a portion of his payment made to that company. (R. 143.)

The label "trade discounts", under which taxpayers recorded these payments in their books did not correctly describe them (R. 454-155), but camcuflaged them (R. 154, 188). The payments to some of the oculists were made in cash at their request. (R. 155.) So far as disclosed by the record, the contracts between taxpayers and the doctors were oral. (R. 155.)

Patients were usually told by the physician that when their glasses were made and fitted by the optical company they should bring them back to the physician for him to check the quality and accuracy of the work done by the optical company and to see if they had been properly fitted. The work to be done by the physician on return to him by the patient might include a re-examination of the eyes of the patient, if such was required. All of these services to be rendered later by the physician were included in the charge made the patient by the physician and, accordingly, no additional charge was made for this service, whether the patient had the prescription filled by an optical company with which the physician had a so-called "kickback" arrangement or an optical company with which the physician had no such agreement. (R. 143, 146-147.)

The same agreements as to "trade discounts"? were made and carried out under similar circum-

stances by taxpayer Helen W. Lilly, trading as Duke Optical Company, for 1943 and 1944. (R. 144, 184.)

Explanations by various witnesses at the hearing, as tending to jsutify the propriety of the arrangement between taxpayers and the physicians, were found by the Tax Court not to be convincing. (R. 146.): 1. No basis was found for the statement by some witnesses that the optician was considered as an agent or employee of the physician. The particular optician was selected by the patient, who was free to make any selection. (R. 146.) 2. In some cases oculistphysicians did their own "dispensing", that is, they not only measured vision and prescribed the lenses, but sent the prescription to some optical company for the grinding and fitting of the lenses to the type of frame selected by the patient, the measurements for which had been taken by the physician. On the return to the physician of the fitted lenses, they were adjusted by the physician to the patient and a total charge was, made for the entire service. In these cases the practice was for the physician to charge his patient the fee for the service rendered and the retail price for the lenses and frames furn shed by the optical company. The physician was then billed by and paid the optical company at the lower wholesale rate for the lenses and frames. (R. 144, 147.) The Tax Court found to be without basis in fact the explanation by some witnesses that the surrender by the physician of the profit he thus would have made (if he had personally bought the lenses and frames and fitted the glasses) constituted consideration for and entitled him to receive a portion of the profit derived by the optician for that service. The employment by the patient of an optician to perform the service in question relieves the physician net only of the work of the fitting and adjusting glasses, but also of the burden of financing their manufacture and eliminates the possibility of loss to the physician through the patient's failing to pay for the glasses. (R. 147.)

The "kickback." practice tended to increase the cost of glasses to a patient. The oculist, in a relationship of great trust and confidence with respect to the patient, was subjected to the temptation of prescribing glasses where not actually necessary, or more expensive lenses than those really needed, and of recommending an inferior optician. The cost of glasses was artificially increased by the inclusion of the physician's commission, for which the physician afforded no consideration to the patient, and of which the patient was, in practically all cases, ignorant. (R. 153, 187.)

One of the two optical companies in Greensboro, North Carolina, a competitor of the City Optical Company, ceased its practice of paying these commissions or "kickbacks" to oculists subsequent to the taxable years and prior to the hearings of the instant proceedings. (R. 144, 155.)

The practice of accepting so-called "kick-backs" from optical companies was frowned upon and considered unethical by the medical profession as a whole, and had been criticized and condemned at meetings of the medical associations and in their professional publications. (R. 143-144, 149.) The Medical Society of North Carolina—the state in which these taxpayers were chiefly engaged in business—had condemned the practice. (R. 144, 187-1889)

"Trade discounts" allowed oculist physicians by the City Optical Company for the three following years were (R. 144):

d	1942	3 \$57, 063, 45 .
	1943	61, 601. 95
-	1944	60, 021, 65

"Trade discounts" allowed oculist physicians by Duke Optical Company for 1943 were \$6,568.87, and for 1944 were \$4,798.35. (R. 144.)

In determining deficiencies against taxpayers, the Commissioner disallowed these trade discounts as deductions (R. 1), and upon redetermination, in an opinion reviewed by the entire court (R. 158), the Tax Court sustained the Commissioner (R. 142-158), Judge Arundell dissenting (R. 158-160). Accordingly, the Tax

² Income for 1942 is relevant by reason of its effect on computation of the 1943 tax under the forgiveness features of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, Sec. 6.

Court decided that there were deficiencies in income taxes due from taxpayer Thomas B. Lilly for the years 1943 and 1944 in the amounts of \$54,953.67 and \$19,301.68, respectively (R. 160–161), and in the case of taxpayer Helen W. Lilly for the years 1943 and 1944 in the amounts of \$26,685.29 and \$23,167.14, respectively (R. 161).

Upon taxpayers' appeal, the court below unanimously affirmed the decision of the Tax Court (R. 183-188), holding that (R. 186):

We certainly will not lend the force of any opinion of this court to sanction, as an "ordinary and necessary" expense of the optician's business, the making and carrying out of such unconscionable and reprehensible contracts for secret kickbacks to a doctor.

SUMMARY OF ARGUMENT

I

A. Petitioners, engaged in the business of making eyeglasses, seek to be allowed to deduct as "ordinary and necessary" business expenses, secret rebates paid by them to doctors who referred patients to them. Since allowance of a deduction depends upon legislative grace, petitioners may prevail only by bringing themselves clearly within the statutory provision. In construing the phrase "ordinary and necessary", it

³ Certain other amounts, not here in issue, appear also to be included in the deficiencies, as found by the Tax Court. (14 Ta C. 1067).

has become well established that a line must be drawn between "legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." Textile Mills Corp. v. Comm'r., 314 U. S. 326, 339. Stated more generally, the rule is that the taxing authorities and the courts will not lend their aid to illegal transactions by permitting tax deductions of expenses arising from activities which frustrate "sharply defined national or state policies proscribing particular types of conduct." Commissioner v. Heininger, 320 U. S. 467, 473.

B. The relationship of doctor to patient is a fiduciary one of the highest order. The secret kick-backs here involved had, the purpose and effect of corrupting that relationship by giving the doctor an undisclosed financial stake in the manufacture of eyeglasses and in the referral of his patient to a particular optical company. Such an agreement is in plain violation of the doctor's fiduciary duties; the optical company which, by making the payment, seeks to corrupt the fiduciary relationship is equally guilty. Under settled judicial principles, the rebate agreement would be unenforcible by either party. Such agreements, moreover, offend applicable statutory policies of the states in which petitioners operated accepted professional standards of the medical profession as disclosed by the record and by official publications of the American Medical Association of which this Court can take judicial notice are in accordance with the foregoing principles. Medical associations have, both before and since the taxable years, explicitly and unequivocally condemned the practice of giving secret rebates disclosed by the present record. The rebating practice is also violative of state and federal antitrust laws. Its necessary effect, as the Tax Court held, is arbitrarily to fix and inflate the prices for eyeglasses. As a result of a federal antitrust consent decree entered in the Northern District of Illinois, leading eyeglass producers have agreed to abandon the practice.

C. The rebate payments were not merely incidentally related to the illegal scheme, they were its heart and center. On the findings below and the facts disclosed by the record, petitioners' participation in that scheme was deliberate and intentional; they granted the rebates because they understood and sought to corrupt the confidential relationship between physician and patient. Moreover, both parties to the agreements sought to conceal them from patients and petitioners sought to camouflage the payments on their books. Since the rules condemning such agreements are well settled and long established, there is no merit to petitioners' suggestion of unfair retroactivity in the decision below.

II

Petitioners' assumption that the courts below found the payments to be ordinary and necessary in the usual sense of those words and denied the deductions solely on grounds of public policy is mistaken. There is no finding by either court that payments were ordinary or necessary in any sense; indeed, both courts found to the contrary. Proof that some optical companies engaged in the practice does not meet petitioners' burden of establishing that the payments were ordinary or necessary. The statutory phrase requires that the expense in question be measured against the "norms of conduct" (Welch v. Helvering, 290 U. S. 111, 114) of the business community generally. Only abysmal cynicism could pretend that this making of secret payments in corruption of a professional relationship of the utmost confidence is normal in American business life.

ARGUMENT

Petitioners, engaged in the business of making eyeglasses, seek by this proceeding to be allowed to deduct from their gross income secret rebates paid by them to doctors who referred their patients to them. Agreements to make such rebates are in clear violation of the well-established standards applicable to a fiduciary relationship

such as that of doctor to patient, of established professional standards of medical practice, and of state and federal antitrust laws. The practice of entering into such agreements is one which reputable doctors will not engage in; no showing has been made that it is accepted by optical companies generally. Broadly stated, the question presented is whether an optical company which does engage in the practice may deduct such rebates as "ordinary and necessary expenses paid in carrying on any trade or business."

It is well settled that allowance of a deduction "depends upon legislative grace," and that "only as there is clear provision therefor can any particular deduction be allowed." New Colonial Co. v. Helvering, 292 U. S. 435, 440; White v. United States, 305 U. S. 281, 292; Deputy v. duPont, 308 U. S. 488, 493; City Ice Delivery Co. v. United States, 176 F. 2d 347, 350 (C. A. 4).

The statutory provision on which petitioners base their claim is Section 23 (a) (1) (A) of the Internal Revenue Code (supra), allowing deduction for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In order to prevail here, they must bring themselves clearly within that provision.

Section 23 (a) (1) (A) does not authorize deduction of all business expenses incurred or paid during the taxable year. In order to be deductible the expense must be "ordinary and neces-

sary." The phrase is in the conjunctive; both requirements must be satisfied. "Congress has not decreed that all necessary expenses may be deducted. Though plainly necessary they cannot be allowed unless they are also ordinary." Deputy v. duPont, supra, p. 497; see also Welch v. Helvering, 290 U.S. 111, 113.

These statutory tests do not admit of any ruleof-thumb application. As Mr. Justice Cardozo said, in Welch v. Helvering, supra, p. 115:

> The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

Both the Treasury and the courts have had repeated occasion to define and apply these tests, as here, to a particular state of facts. Welch v. Helvering, supra, 290 U.S. at 116; Deputy v. duPont, supra, 308 U. S. at 496; Textile Mills Corp. v. Commissioner, 314 U. S. 326; Commissioner v. Heininger, 320 U. S. 467; McDonald v. Commissioner, 323 U. S. 57; City Ice Delivery Co. v. United States, supra, p. 350. This Court has stated that the question whether an expense is ordinary and necessary is generally a question of fact and that "each case should depend upon its peculiar circumstances." Commissioner v. Heininger, supra, 320 U.S. at 473. It has pointed out that the Commissioner's ruling has the support of a presumption of correctness. Welch v. Helvering, supra, 290 U.S. at 115. And it has

repeatedly declared that on such issues as this it will pay great deference to the expert judgment of the Tax Court. E. g., Commissioner v. Heininger, supra, 320 U. S. at 475; McDonald v. Commissioner, supra, 323 U. S. at 64.

We believe that petitioners have failed to establish their right to the claimed deductions, and that the Commissioner's ruling, approved by the Tax Court sitting en banc and the unanimous court below, should be sustained. In the following portions of this brief we shall demonstrate, first, that compelling considerations of public policy require that the practice of entering into "such unconscionable and reprehensible contracts for secret kickbacks" (R. 186) in violation of well-established judicial and professional standards should not be assisted by allowance of tax deductions for payments made pursuant to such contracts, and, second, that even apart from such considerations of public policy, the kickbacks here involved have not been shown to be ordinary.

^{*}This principle of respect for the expert judgment of the Tax Court on questions of the application of a broad general standard to a myriad variety of particular factual situations is based on the view that a court which can deal only intermittently and occasionally with the manifold applications of such a statutory test should be reluctant to overturn the considered judgment of a tribunal which has continuing daily contact with such issues. That principle has special force where, as here, the decision of the Tax Court was reviewed by the entire Court and approved with but a single dissent.

or necessary to the carrying on of the optical business.

T

Compelling considerations of public policy preclude allowance of the deduction here claimed

A. Expenses arising out of agreements which are illegal, or which frustrate sharply defined national or state policies, may not be deducted .-Many decisions settle that when Congress, in the exercise of its favor, permitted deduction of "ordinary and necessary" business expenses, it did not mean to include expenses whose allowance would assist through tax consequences in the financial success of activities denounced in the states where the revenue laws operate, or condemned under federal law. Congress must not be regarded as legislating in a vacuum. The rule has been evolved that no deduction should be allowed as "ordinary and necessary" which "frustrates sharply defined national or state policies proscribing particular types of conduct". Commissioner v. Heininger, supra, 320 U. S. at 473; "in the nature of things, public policy must narrow the field of allowable deductions which rest as they do upon legislative indulgence." National Brass Works v. Commissioner, 182 F. 2d 526. 530 (C. A. 9). Moreover, it can hardly be supposed: that in limiting deductions to expenses which are "ordinary and necessary" Congress contemplated that deliberate violation of law is ever a necessary or an ordinary activity of business men (ibid).

Nor is there any lack of logic in taxing income a from illegal sources (United States v. Subivan, 274 U. S. 259; see also United States v. Rutkin, ° 189 F. 2d 431 (C. A. 3), pending on certiorari, No. 195, this Term) and refusing a deduction for expenses resting in illegality. This result was sustained in Cohen v. Commissioner, 176 F. 2d 394, 397, 400-401 (C. A. 10), where both types of taxpayers were involved. See also Silberman v. Commissioner, 44 B. T. A. 600, 603-604. The broad definition of income under Internal Revenue Code, Section 22 (a), covers gains or profits on income from any source whatsoever; on the other hand, the privilege of deducting business expenses is strictly limited to expenses which are "ordinary and necessary.""

Accordingly, the Treasury, the Tax Court and the federal courts have repeatedly drawn a line between "legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." Textile Mills. Corp v. Commissioner, 314 U. S. 326, 339. In that case, in upholding the validity of an interpretative Treasury Regulation defining the words. "ordinary and necessary" as excluding certain

Thus, legitimate expenses of an illegal business are decoductible, but expenditures made in carrying on activities which are in themselves in contravention of law are not deductible as business expenses. Cohen v. Commissioner, supra, p. 400; Silberman v. Commissioner, supra, p. 603-604.

types of lobbying expenses, this Court, in words equally applicable to the present case, said (pp. 338-339):

Petitioner's argument that the regulation is invalid likewise lacks substance. The words "ordinary and necessary" are not so clear and unambiguous in their meaning and application as to leave no room for an interpretative regulation. numerous cases which have come to this Court on that issue bear witness to that. Welch v. Helvering, 290 U.S. 111; Deputy v. duPont, 308 U. S. 488, and cases cited. Nor has the administrative agency usurped the legislative function by carving out this special group of expenses and making them nondeductible. We fail to find any indication that such a course contravened any Congressional policy. Contracts to spread such insidious influences through legislative halls have long, been condemned. Trist, v. Child, 21 Wall. 441; Hazelton V. Sheckells, 202 U. S. 71. Whether the precise arrangement here in question would violate the rule of those cases is not material. The point is that the general policy indicated by those cases need not be disregarded by the rule-making authority in its segregation of non-deductible expenses. There is no reason why, in absence of clear Congressional action to the contrary, therule-making authority cannot employ that general policy in drawing a line between legitimate business expenses and those arising from that family of contracts to

which the law has given no sanction. The exclusion of the latter from "ordinary and necessary" expenses certainly does no violence to the statutory language. The general policy being clear it is not for us to say that the line was too strictly drawn. [Italics supplied.]

That decision was approved in Commissioner v. Heininger, supra, in which this Court again recognized that (320 U.S. at 473):

Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in § 23 (a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct.

This principle has been applied to a wide variety of situations. Some examples of its application are the following:

Partile Mills Corp. v. Commissioner, supra (expenses incurred for certain types of lobbying and political pressure activities with a view to influencing federal legislation); Rugel v. Commissioner, 127 F 2d 393, 395 (C. A. 8th) (payments to an influential party precinct captain in

Although the Textile Mills case involved an interpretative regulation, the principles which it approved may, in the absence of regulation, properly be applied by the courts. Indeed, none of the other cases sited on this and the following pages rested on the language of any regulation.

order to obtain a state printing contract); Harden M. Loan Co. v. Commissioner, 137 F. 2d 282, 284 (C. A. 10th) (payments for exerting political influence made under the guise of selling commissions on road-building materials); Cohen 'v. Commissioner, 176 F. 2d 394, 400-401 (C. A. 10th) (payments for protection afforded gambling establishments against raid and arrest by law enforcement officers); Excelsior Baking Co. v. United States, 82 F. Supp. 423 (D. Minn.) (large sums paid surreptitiously to disreputable men to negotiate a labor contract concealed by deceptive entries in taxpayer's books); Kelley-Dempsey & Co. v. Commissioner, 31 B. T. A. 351 (expense of commercial extortion); Easton Tractor & Equipment Co. v. Commissioner, 35 B. T. A. 189 ("commissions" paid for personal influence in obtaining public contracts); Kyne v. Commissioner, 35 B. T. A. 202 (amounts expended in promoting legislation which would legalize horse racing); Nicholson v. Commissioner, 38 B. T. A. 190, 198-199 (payments, amounting to one-third of the profit, made to a state senator for his political influence in obtaining favorable conditions covering the bidding on a public contract); Maddas v. Commissioner, 40 B. T. A. 572, 581-582, affirmed on another ground, 114 F. 2d 548 (C. A. 3d) (bribes paid prohibition officers to secure immunity from prosecution); Silberman v. Commissioner, 44 B. T. A. 600 (expenditures for use of booths and for services of persons registering

bets, activities which in themselves contravened state "law); Weather-Seal Mfg. Co. v. Commissioner, 16 T. C. 1312, pending on appeal (C. A. 6th) (wages paid in contravention of Federal Wage Stabilization Law and Executive Order promulgated thereunder); Reliable Milk & Cream Co. v. Commissioner, decided August 20, 1938 (1938 P-H B. T. A: Memorandum Decisions, par. 38,290) (payments made to racketeers under fear of assault of milk dealers and burning of trucks); Giubbini v. Commissioner, decided October 27, 1939 (1939 P-H B. T. A. Memorandum Decisions, par. 39,471) (sums paid drugstore for referring clients to an abortionist); Lewis v. Commissioner, decided April 17, 1941 (1941 P-H&B. T. A. Memorandum Decisions, par. 41,228) (sums paid for private information enabling taxpayer to become the low bidder on a grading job of the payec's employer); Barlow v. Commissioner, decide May 19, 1943 (1943 P-H T. C. Memorandum Decisions, par. 43,237) (attorney's fees in excess of ten per cent limit fixed by a private act appropriating an award of the Court of Claims).

On the same reasoning, fines and penalties paid to the national or state governments are not comprehended within the meaning of "ordinary and necessary" husiness expenses since their allowance would, by way of a tax advantage, constitute a partial remission, thus circumventing the public policy pursuant to which the sanctions are imposed. Great Northern Ry. Co. v. Commis-

sioner, 40 F. 2d 372 (C. A. 8th); certiorari-denied, 282 U. S. 855; Burroughs Bldg. Material Co. v. Commissioner, 47 F. 2d 178 (C. A. 2d); Chi. R. I. & P. Ry. Co. v. Commissioner, 47 F. 2d 990, 991 (C. A. 7th), certiorari denied, 284 U. S. 6189 Tunnel R. R. v. Commissioner, 61 F. 2d 166, 173-174 (C. A. 8th), certiorari denied, 288 T. S. 604; National Outdoor Advertising Bureau v. Helvering, 89 F. 2d 878, 881 (C. A. 2d); Standard Oil Co. v. Commissioner, 129 F. 2d 363 (C. A. 7th); Helvering . Superior Wines & Liquors, 134 F. 2d 373 (C. A. 8th), certiorari denied, 317 U. S. 688; Commissioner v. Longhorn Portland Cem. Co., 148 F. 2d 276 (C. A. 5th), certiorari denied, 326 U. S. 728; Universal Atlas Cement Co. v. Commissioner, 171, F. 2d 294 (C. A. 2d), certiorari denied, 336 U. S. 962; Jerry Rossman Corp. v. · Commissioner, 175 F. 2d 711, 713 (C. A. 2d); National Brass Works v. Commissioner, 182 F. 2d 526 (C. A. 9th), on remand to Tax Court, 16 T. C. 1051, pending an appeal from remand; Scioto Provision Co. v. Commissioner, 9 T. C. 439; Garibaldi & Cuneo v. Commissioner, 9 T. C. 446; Henry Watterson Hotel Co. v. Commissioner, 15 T. C. 902, pending on appeal (C. A. 6th).

Petitioners, in effect, ask that this "so-called doctrine of public policy" (Brief, pp. 6, 15),

The English courts have reached similar results in applying the cognate provisions of the British Income Tax Acts. See Inland Revenue Commissioners v. Von Glehn [1920] 2 K. B. 553; Inland Revenue Commissioners v. Warnes & Co., [1919] 2 K. B. 444.

thus approved and applied by this Court and by innumerable decisions of the Tax Court and courts of appeals, should be overruled. 'They urge that the rule is in "plain disregard of the language" of Section 23 (a) (1) (A) (Brief, p. 6; see also p. 16) and "cannot be adequately justified" (Brief, p. 6). They apparently seek a hold-a. ing that the Commissioner may not "deny deductions on the basis of public policy." (Brief, p. 7.) Their argument in this respect has two branches, first, that Section 23 (a) (1) (A) is concerned solely with net income, so that any denial of deduction for an expense actually paid or incurred contravenes the statute (Brief, pp. 8-15), and second, that experience has established that the public policy rule as applied to business deductions is unsatisfactory if not unworkable (Brief, pp. 15-25).

The first branch of their argument ignores the fact that Congress did not authorize deduction of every business expense paid or incurred, but only of such expenses paid or incurred as were "ordinary and necessary." There can be no doubt that "Congress has power to condition, limit or deny deductions from gross income in order to arrive at the net that it chooses to tax." Helvering v. Ind. Life Ins. Co., 292 U. S. 371, 381. As Merten's states (1 Mertens, Law of Federal Income Taxation, Sec. 5.10, pp. 186-187):

The courts have repeatedly viewed deductions as matters of legislative grace, so that "net income" becomes a statutory rather than an economic concept under which items which might be considered as gross income by the business man are treated as taxable income by statute.

Again, the same writer comments with respect to language in Treasury Regulations 111, Sec. 29.21-1, referred to by petitioners (Brief, p. 9) (2 Mertens, Law of Federal Income Taxation, Sec. 12.04, pp. 127-128):

The regulations provide that the taxpayer's method of accounting will be used if "the method so used is properly applicable in a determining the net income of the taxpayer for purposes of taxation." Similarly, in dealing with the definition of taxable net income, the Treasury throws out a warning that such income "is a statutory conception" but adds the suggestion that it follows commercial usage except as to exemptions and as to deductions for partial losses. However, it frequently does not follow such usage; taxable income includes many items which are not ordinarily so considered and the statute either disallows entirely or materially limits the deduction of many disbursements considered ordinarily, in common accounting practice, as expenses or losses.

Indeed, the courts have repeatedly sustained treatment as taxable net income of items which might be considered commercially as gross income, in Stanton v. Baltic Mining Co., 240 U. S. 103, 113 (depletion deduction); Helvering v. Ind. Life

Ins. Co., supra (depreciation deduction); Philadelphia Fire & Marine Ins. Co. v. United States, 3 F. Supp. 655 (C. Cls.), certiorari denied, 290 U. S. 703 (limitation on net losses); Phipps v. Bowers, 49 F. 2d 996 (C. A. 2d), certiorari denied, 284 U. S. 641 (interest deduction). The circumstance that the income tax system is based on annual accounting periods may also result in taxation of gross income in a sense. Burnet v. Sanford & Brooks Co., 282 U. S. 359; Spring City Co. v. Commissioner, 292 U. S. 182, rehearing denied, 292 U. S. 613.

Petitioners seek support for their contention from congressional debates of some thirty-eight years ago (Br. 11-13), with respect to the language of the loss deduction, as enacted in the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Sec. II, B and G (b). As a matter of fact, loss deductions have been denied when incurred in commission of acts forbidden by law. See Wagner v. Commissioner, 30 BTA 1099; Anderson v. Commissioner, 35 BTA 10. Moreover, the rigor-

⁷ See Revenue Act of 1934, c. 277, 48 Stat. 680, Set. 23 (g), now Internal Revenue Code, Sec. 28 (h), whereby wagering losses were limited to the extent of wagering gains. In proposing this provision the House Committee explained this amendment (H. Rep. No. 704, 73d Cong., 2d sess., p. 22 (1939-1 Com. Bull. (Part 2) 554, 570)).

[&]quot;Section 23 (g), Wagering losses: Existing law does not limit the deduction of losses from gambling transactions where such transactions are legal. Under the interpretation of the courts, illegal gambling losses can only be taken to the extent of the gains on such transactions. A similar limital tion on losses from legalized gambling is provided for in the

ous requirements that expenses, to be deductible, must be "ordinary and necessary" does not apply to losses. Internal Revenue Code, Section 23 (e); 5 Mertens, supra, Sec. 28.37. Finally, taxpayers argument based on this distant floor discussion asks this Court, in effect, to repudiate its holdings and reasoning in the Textile Mills and Heininger cases, supra, and numerous lower court decisions. Congress must be presumed to have known during the past thirty-eight years of the repeated administrative and judicial construction of the business expense deduction provision, but significantly made no change in its terms.

The second branch of their argument comes to little more than an assertion that denial of business expense deductions on grounds of public policy could lead to undesirable results if pushed too far, and that in close cases the courts, applying the rule, have on occasion reached results either inconsistent or difficult to reconcile. This case, however, does not by any conceivable stretch of the imagination involve the question whether the Commissioner may "pass upon the social desirabil-

bill. Under the present law many taxpayers take deductions for gambling losses but fail to report gambling gains. This limitation will force taxpayers to report their gambling gains if they desire to deduct their gambling losses."

Certainly there can be no basis for a suggestion that the present Congress is more willing than the courts have been to confer tax benefits on illegal activities. On the contrary, the present tendency is in the opposite direction. See e. g., the recommendations of the Kefauver Committee, S. Rep. 307, 82d Congress, 1st sess., pp. 11-12.

ity of business outlays" and "evince his displeasure" by denying a deduction. (Pet. Br. p. 8). As this Court pointed out in Commissioner v. Heininger, supra, denial of business deductions on publie policy grounds is limited to cases of violation of "sharply defined national or state policies." It is because the payments here involved clearly violate state and federal policies which have been sharply defined, and which were so defined prior to the taxable years, that their deduction has been denied. As we shall show (Pt. B, infra) the unconscionable and reprehensible character of the agreements pursuant to which these secret kickbacks were made is beyond question. For the same reason, the asserted difficulties in applying the public-policy doctrine to cases of doubtful illegality have no bearing. In any event, we believe those difficulties are no more than inevitably arise in the application of a legislative test phrased in terms of such generality as "ordinary and necessary." Indeed, the decisions applying this phrase in areas involving no question of public policy te. g. Welch v. Helvering, supra; McDonald, v. Commissioner, supra) present problems at least equally difficult of solution. Compare Jordan v. De George, 341 U. S. 223, 229-232.

refer to as the "so-called doctrine of public policy" has been well settled for many years, during which the provision permitting deduction of only such business expenses as are "ordinary and

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necessary" has been repeatedly reenacted. At least in the absence of a most compelling showing that the rule is unsound, we believe it is for Congress, not the courts, to change the settled construction of the statutory phrase.

In addition to attacking root, stalk and branch, the rule approved in the Textile Mills and Heininger cases, petitioners seek to limit its scope in a way not heretofore approved by this Court and unsupported by decisions of other courts. Thus, while grudgingly conceding that "a doctrine of public policy might in some cases properly apply where a federal statute has been violated '(Br. p. 21) they in effect urge that it has no applica-/ tion to violations of state statutes, or of nonstatutory policy whether federal or state. As we shall point out (infra, pp. 29-49) the agreements under which these payments were made violate federal as well as state statutes, and statutory as well as non-statutory policies. But in any event, the limitation which petitioners suggest has been/ clearly rejected by this Court. In the Heininger ease, supra, this Court was careful to describe the rule as applicable to "national or state policies proscribing particular types of conduct." (320 U. S. at 473.) And its decision in the Textile Mills case denying a deduction for lobbying expenses rested, not on statute, but on judicial decisions condemning contracts of the general type involved. In holding that deductions could be denied for payments "arising from that family of

contracts to which the law has given no sanction" (314 U. S. at 339), it plainly intended to include contracts of all kinds whose performance is inconsistent with public policy. See also cases cited, supra, pp. 19-21,

B. The kick-back agreements here disclosed offend a number of sharply defined and long established judicial and legislative policies

1. Under settled legal principles the kick-back agreements are illegal and void as in plain conflict with the fiduciary relationship of a doctor to his patient.—"The relationship of patient and physician is to the highest possible degree a fiduciary one, involving every element of trust and confidence." Stryker, Courts and Doctors (1932), p. 9. Accordingly, that relationship is governed by the standards expressed by Judge Cardozo in Meinhard v. Salmon, 249 N. Y. 458, 464:

Many forms of conduct permissible in a workaday-world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

It is by that exacting "way of life" (Welch v. Helvering, supra, 290 U.S. at 115) that the present agreements must be judged.

Even as to mere agents the controlling rule is stated in 6 Williston on *Contracts* (Rev. ed.), Sec. 1737, p. 4905:

A bargain by an agent, even though acting as such without compensation, to receive without his principal's consent compensation from others for the performance of his agency is invalid.

Moreover, as Williston further points out (p. 4906), probably any bargain, for reward, to influence by apparently disinterested advice the conduct of a third person is obnoxious to public policy, even when neither party at the time bears a fiduciary relation to the person to be influenced. He elaborates the principle as follows (pp. 4906–4907, fn. 10):

The rule relating to a bargain to influence the conduct of a third person by apparently disinterested advice may be summarized thus, a fiduciary owes a double duty, to disclose his own interest in inducing action by the principal, and whatever he knows bearing on the proposed action; one not a fiduciary owes to one whom he seeks to influence a single duty, to disclose his interest in inducing action. A contract to violate the duties or duty so raised is contrary to public policy and invalid. * * *

Clearly an agreement, for a secret consideration, to influence one with whom the promisor stands in a confidential relation is illegal [citing cases]; or to influence one

who may consult him in a confidential relation, * * *. [Italies supplied.]

To the same effect, see 2 Restatement, Contracts, Sec. 570.

This principle that one cannot at the same time serve two incompatible masters has been applied in innumerable decisions. Mosser v. Darrow, 341 U. S. 267; City of Findlay v. Pertz, 66 Fed. 427, 434 (C. A. 6th); Reilly v. Beekman, 24 F. 2d 791 (C. A. 2d); Wolfe v. International Reinsurance Corp., 73 F. 2d 267 (C. A. 2d), certiorari denied, 294 U.S. 725; Maryland Trust Co. v. National Meckanics Bank, 102 Md. 608; Humphrey v. Eddy Transportation Co., 107 Mich. 163; Kelley-Dempsey & Co. v. Commissioner, supra: Easton Tractor & Equipment Co. v. Commissioner, supra. Statutes alone have never determined public policy and the courts traditionally also have established rules proscribing conduct as against the public welfare." There is

In Winfield, Public Policy In The English Common Law, 42 Harv. L. Rev. 76 (1928), the author states (p. 97):

^a In Hurd v. Hodge, 334 U. S. 24, 34–35, this Court said: "The power of the federal courts to enforce the terms of private agreements is at all times exercised subject to the restrictions and limitations of the public policy of the United States as manifested in the Constitution, treaties, federal statutes, and applicable legal precedents. Where the enforcement of private agreements would be violative of that policy, it is the obligation of courts to refrain from such exertions of judicial power."

[&]quot;* * violations of obvious ethical or moral standards" may provide a "plain indication" of "dominant public policy." Muschany v. United States, 324 U.S. 49, 66-67.

nothing novel or nebulous about the well-settled rule applicable here, which proscribes as illegal bargains such as that between taxpayers and the physicians.

Thus, expressing the principle here governing the Court of Appeals for the Second Circuit said in Reilly v. Beekman, supra, at 794:

It cannot be disputed that, if Reilly was in a fiduciary relation to Mrs. Trenkman when he recommended Beekman to her as her attorney, he could not agree to profit from the business arising out of the introduction without her knowledge and consent. This is because Mrs. Trenkman was entitled to his disinterested advice as to the attorney to be recommended to her. That advice was not likely to be disinterested, if affected by the consideration of whether or not he could make a profit out

At another point, the author defines public policy as (p. 92) "a principle of judicial legislation or interpretation founded on the current needs of the community."

[&]quot;But the better view seems to be that the difficulty of discovering what public policy is at any given moment certainly does not absolve the bench from the duty of doing so. The judges are bound to take notice of it and of the changes which it undergoes, and it is immaterial that the question may be one of ethics rather than of law. The basis for their decision is 'the opinions of men of the world, as distinguished from opinions based on legal learning.' Of course it is not to be expected that men of the world are to be subpoensed as expert witnesses in the trial of every action raising a question of public policy. It is the judges themselves, assisted by the bar, who here represent the highest common factor of public sentiment and intelligence."

of the recommendation of a particular per-Moreover, she was entitled to have him recommend an attorney, the amount of whose fees would depend on the services he had to perform, and would not be affected by what he had to pay out to the plaintiff for an introduction to the client. Auerbach v. Curie, 119 App. Div. 176, 104 N. Y. S. 233; Alpers v. Hunt, 86 Cal. 78. 24 P. 846, 9 L. R. A. 483, 21 Am. St. Rep. 17; McNair v. Parr, 177 Mich. 327, 143 N. W. 42. If she knew Reilly's interest, and what he was to receive, and consented to the arrangement, the case would be different. She might be willing to sanction it, because it would save her from paying Reilly for his advice, or for other reasons. If, as is contended, Reilly was not acting in an ordinary sense as an agent for Mrs. Trenkman in respect to her business and financial affairs, and simply as a friend recommended a lawyer, when requested so to do, we think he stands in no better position. To be sure. in that case he would be only a volunteer; but if he offered merely as a friend to recommend an attorney, with no knowledge on her part that he was to derive any benefit from the recommendation, she was deprived of the disinterested advice which he assumed to give when he was under the pay. of Beekman in making the recommendation.

This fundamental common law principle of public policy proscribing the corruption of an agent or fiduciary is particularly applicable here,

where not merely an ordinary commercial transaction is in question, but the fiduciary physiciafipatient relationship, entitling the patient to rely
with the highest degree of confidence and trust on
the disinterestedness of his physician. Even
though the secret payment actually results in no
damage to the patient, or even if the physician
acted in good faith, public policy condemns the
arrangement. The law/proscribes all temptation
for a fiduciary to be influenced by his own interest
to the detriment of his principal. Mosser v. Darrow, 341 U. S. 267; City of Findlay v. Perts,
supra, p. 434; see also authorities cited in the
opinions below, R. 150-151, 186.

Here, as the courts below found, the kick-back practice obviously invites serious evils (R. 153, 187): (1) the prescription of glasses where not actually necessary; (2) the prescription of more expensive lenses than really needed; (3) the recommendation of an inferior opticien; and (4) an artificial increase in the cost of the glasses by the inclusion of the physician's commission, for which the physician affords no value to the patient. The bait of the secret consideration, which taxpayers offered, hopelessly divides the trusted confidant's interest. See Lieberman v. State Board.

¹⁰ See respondent's Evaibit T (R, 162-180), complaint in anti-trust suit brought by the United States against American Optical Company and a number of physicians, discussed below (pp. 47-49), and final judgment of consent against defendants entered in that action on May 16, 1951, subsequent to the decision below (Appendix B, infra, pp. 83 et seq.).

of Examiners in Optometry, 130 Conn. 344, 350-351.

These principles, moreover, reach not only the physician who violates his fiduciary obligations but also the taxpayers who induced and procured such violation, and who thereby participated directly in the corruption of the fiduciary relationship. Contrary to taxpayers' argument (Br. 27), the corrupt agreements were illegal and contrary to public policy for all purposes, no merely in the sense that the physician would not be able to recover upon them. The law inhibits in every respect their making and carrying out, 'Under established rules of contract, agency and trust, the patients could have recovered the rebates. from either taxpayers or the physicians; the opticians could not have recovered back the rebates from the physicians. Restatement, Restitution, Sec. 138; Restatement, Contracts, Sec. 598.

The judicial rules prohibiting such agreements are thus well settled and of long standing. But it is not necessary to rely on judicial rules for the same public policy has been expressed in legislation. Under familiar criminal statutory provisions, common to many states, the giving of consideration to an agent with intent to influence his action in relation to his principal's business constitutes a misdemeanor. Such statutes were in deffect during the taxable years in the states in which petitioners operated. 1 General Statutes of North Carolina (1943), Sec. 14–353; Virginia

Code of 1942, Annotated, Sec. 4712. Thus, commercial bribery is prohibited under criminal sanction in ordinary business transactions. While the present agreements may or may not fall technically within the letter of these statutory provisions, they are plainly violative of the policies which the statutes reflect."

Indeed, several states have expressly declared the practices here shown to be a misdemeanor, both as to the payor, and recipient of such commissions. Such provisions have been adopted by the States of Washington 12 and Califor-

12 Remington's Revised Statutes of Washington, Annotated

(1949 Supp.):

"Any person violating the provisions of this section is guilty of a misdemeanor. [L. '49, ch. 204, § 1.]"

¹¹ The Government does not suggest that the mere existence of a state law, prohibiting a particular transaction or relationship, is determinative of the question of deductibility. It is not a particular law but the broader public policy that is crucial. That policy may, of course, be evidenced by state . laws pointing in one general direction.

[&]quot;§ 10185-14. Rebates for referral of patients unlawful.-It shall be unlawful for any person * * to pay, or offer to pay or allow, directly or indirectly, to any person licensed by the State of Washington to engage in the practice of medicine and surgery, * * and it shall be unlawful for such person to request, receive or allow, directly or indirectly, a rebate, refund, commission, unearned discount or print by means of a credit or other valuable consideration in connection with the referral of patients to any person, firm, corporation or association, or in connection with the furnishings of medical, sargical or dental care, diagnosis, treatment or service, on the sale, rental, furnishing or supplying of clinical laboratory supplies or services of any kind, or any other goods; services or supplies prescribed for medical diagnosis, care or treatment.

nia.¹³ And recent legislation of North Carolina, where taxpayers principally operated, proxiding for regulation and licensing of dispensing opticians, has expressly forbidden the practice and imposed criminal penalty on any optical company engaging in it.¹⁴

^{is} California Business and Professions Code (Deeping, 1949 Pocket Supp.):

"§ 650. Rebates, etc. for referral of patients, clients and customers unlawful.—The offer, delivery, receipt or acceptance, by any person licensed under this division of any unearned rebate, refund, commission, preference, patronage dividend, discount, or other unearned consideration, whether in the form of money or otherwise, as compensation or inducement for referring patients, clients, or customers to any person, irrespective of any membership, proprietary interest or co-ownership in or with any person to whom such patients, clients or customers are referred is unlawful. Added by Stats. 1949, ch. 899, § 1.]

"§ 652. Violation of article to constitute unprofessional conduct and grounds for suspension or revocation of license: Conduct of proceedings: Misdemeanor.—* In addition, any violation constitutes a misdemeanor as to any and all persons offering, delivering, receiving, accepting or participating in any such rebate, refund, commission, preference, patronage dividend, unearned discount or consideration, whether or not licensed under this division. [Added by Stats. 1949, ch. 899, § 1.]"

¹⁴ North Carolina Session Laws (1951), c. 1089, Secs. 21, 23:

"Sec. 21. Any person, firm or corporation who shall violate any provision of this Act for which no other penalty has been provided shall, upon conviction, be fined not more than two hundred (\$200.00) dollars or imprisoned for a period of not more than twelve (12) months, or both, in the discretion of the court.

2. The obnoxious nature of such agreements has been repeatedly recognized by the medical profession.

These conclusions, drawn from judicially created standards applicable to all fiduciaries, are confirmed by standards repeatedly insisted upon by the medical profession itself. The accepted estandard of medical practice is far from being as low as the burden of petitioners' argument would imply. The tribunals below found (R. 144, 187-188 that the disputed practice was considered unethical by the medical profession as a whole and had been criticized and condemned at meetings of medical societies and in professional publications. It had been condemned by the Medical Society of North Carolina, although no direct action had been taken by that society against any individual physician.

In addition, this Court may properly take judicial notice of authoritative pronouncements by the American Medical Association and by the Chairman of its section on Ophthalmology, as evidencing the standards approved by that body

(In effect April 14, 1951.)

⁽Continued)

[&]quot;Sec. 23. It shall be unlawful for any person, firm or corporation to offer or give any gift or premium or discount, directly or indirectly, or in any form or gannier participate in the division, assignment, rebate or refund of fees or parts thereof or to engage in advertising in any form or manner that would urge the public to seek the services of any specific professional person or group of persons engaged in the field of refraction and visual care."

as norms of professional conduct. Cf. Muller v. Oregon, 208 U. S. 412, 419-421; Parker v. Brown, 317 U. S. 341, 363-366; H. J. Heinz Co. v. Labor Board, 311 U. S. 514, 523-525; Universal Camera Corp. v. Labor Bd., 340 U. S. 474, 494. Those pronouncements leave no doubt that authoritative medical opinion condemns such arrangements on essentially the same grounds as those reflected in the governing judicial standards referred to above. For the convenience of the Court we have reprinted in "Appendix A" infra pp. 59-82, a number of excerpts from published statements from the foregoing sources bearing on the point;" we shall refer here to only a few of the most significant.

Thus, the Principles of Medical Ethics of the American Medical Association (1943) expressly declares, "It is unprofessional to accept rebates on prescriptions or appliances, " * "." Art. I, Sec. 5 (p. 60, infra), The 1949 revision of the

The material contained in Appendix A, infra, consists of excerpts from Principles of Medical Ethics of the American Medical Association (pp. 59-63, infra); an address read before the Section on Ophthalmology of the American Medical Association by its chairman at the annual session of the Association is 1941, published in the American Medical Journal (pp. 63-74, infra), and editorials published in the American Medical Journal in 1946 and 1948, the last being formally signed by the Association's officers and trustees (pp. 75-82, infra). Appendix A, with the exception of the excerpt marked "II", pp. 62-63, infra, was before the court below, and some of the materials contained in it were referred to by the court below (R. 187).

Principles of Medical Ethics repeats this statement and adds (Chapter I. Sec. 6: pp. 62-63, infra) that the physician.

should receive his remuneration for professional services rendered only in the amount of his fee specifically announced to his patient at the time the service is rendered or in the form of a subsequent statement, and he should not accept additional compensation secretly or openly, directly or indirectly, from any other source. [Italics supplied.]

A leading article in the Journal of the American Medical Association for August 16, 1941 (117 J. A. M. A. 497-499), by Dr. Albert C. Snell, Chairman of the Section on Ophthalmology of that Association, entitled, "Some Principles of Medical Ethics Applied to the Practice of Opthalmology," and stated to have been read at the Ninety-Second Annual Session of the Association in June, 1941, pp. 63-74, infra, discusses the application of the Association's code of medical ethics to the secret commission or rebate practice here under consideration. Dr. Snell describes the precise practice revealed by the present record and states as to it (p. 72, infra):

There can, of course, be no justification whatever for the receiving of a percentage repate for glasses which are furnished by opticians who provide all the services connected with the supplying of glasses. This practice violates every ethical medical

principle of practice. Under these circumstances the patient either receives an inferior quality of product or an inferior optical service.

He concludes his discussion with the following (pp. 73-74, infra):

It seems to me that the crux of unethical practices lies primarily in some secret form of rebate, differential or kick-back—to some furtive participation in the profits connected with the supplying of lenses and their mountings, which participation is done without the knowledge of the patient. As a consequence of this method of practice, patients are compelled to pay for services which are not rendered either by the ophthalmologist or by the optician. Evidently this practice does not consider the best interest of the patient.

When an adequate and proper fee is made for the professional services rendered, the ophthalmologist is not ethically entitled to some additional fee from the sale of the glasses. When any rebate method is practiced, by whatever name it is designated, which method requires the optician to split the profits with the ophthalmologist, it is probable either that an inferior quality of ophthalmic goods is supplied or that the optician's service is lacking in high standard. All rebates are a form of fee splitting which cannot be defended on any ethical ground. There can be no justification for trading on the confidence of the

patient openly or secretly, but the secret practice is the more reprehensible. These forms of unethical conduct are emphatically condemned by the medical profession, and those who practice them are bringing disrespect, derision and dishonor to the profession. [Italics supplied.]

In 1942, the House of Delegates of the American Medical Association approved a resolution condemning "the unscrupulous practice of rebates to physicians " engaged in by various commercial organizations, laboratories, supply houses ... "as "clearly in violation of the Principles of Medical Ethics" and directing disciplinary action against doctors engaging in such a practice. (Infra, pp. 76-77.) Indeed, as early as 1924 the Association's section on Ophthalmology had adopted a resolution (quoted infra, pp. 76):

That the receptance of commissions or considerations, either directly or indirectly, from opticians and optical houses in the sale of glasses is absolutely contrary to all our standards of medical ethics and is just as reprehensible as the splitting of fees.

Perhaps the most comprehensive statement of authoritative medical opinion on the point is contained in an editorial formally signed by the trustees and officers of the American Medical Association and published on January 17, 1948 (136 J. A. M. A. 176-177) entitled "Rebates, Kick-

backs, Commissions and Medical Ethics." Although published subsequent to the taxable years involved, the editorial shows on its face that it represents a statement of professional standards long antedating the taxable years. In this editorial the trustees and officers of the Association emphatically pointed out that (p. 78, infra):

The pride of medicine as a profession has always been its freedom from the taint of barter and trade in the sick patient. Physicians must give their wholehearted devotion to the care of the patient; no other objective must be given precedence over consideration of the patient's need.

It mentions (p. 79, infra), that:

Ophthalmologists have sent the patient for lenses to opticians who returned a proportion of the fee rather than to the optician who rendered the highest quality of optical service.

The editorial further states (pp. 79-80, infra):

Wherever barter and trade have insinuated their insidious and evil aspects into the practice of medicine, the quality of the service has depreciated. The morals of the physicians and the commercial agencies that deal in these unwholesome profits in this marketing of medical care have already deteriorated.

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¹⁶ Authorization was formally given by the board of trustees for the publication of this editorial at its meeting in January, 1948 (136 J. A. M. A. 476). The editorial is set out in full at pp. 78–82, infra.

From the beginning of its entrance on the medical scene, the American Medical Association has fought this menace to the quality of medical service and to the good repute of medical practice. Resolutions have been passed by the official bodies of the Association unequivocally condemning such practices. The Judicial Council has repeatedly urged the expulsion or other action against physicians proved to have participated in such procedures. The leaders of surgery, ophthalmology, orthopedic surgery and pharmacy have been unanimous in pointing out the extent to which such commercial considerations may break down the good repute of the specialties concerned.

The Association's officers and board of trustees further point out (pp. 80-81, infra):

As might have been anticipated, the ultimate development was recognition by governmental agencies of the fact that the unprotected public was being exploited by such methods. The first warning and one of tremendous significance was the indictment by the Department of Justice of two manufacturing optical agencies and of a considerable number of ophthalmologists who participated in a plan which took hundreds of thousands of dollars from unknowing patients. A full report appeared in The Journal of the American Medical Association when the Department of Justice

¹⁶a See infra, pp. 47-48.

took this action during 1946." A popular periodical with millions of circulation has called on the medical profession to cleanse itself as it has repeatedly cleaned its own house in the past.18 The House of Delegates asked the Secretary of the American Medical Association to call the situation to the attention of every state and county medical society in the nation and to urge on these societies the initiation of the necessary stepsotoward ridding medical practice of these parasites. The Better Business Bureaus in several large communities, notably Los Angeles, have begun a campaign of enlightenment of the public regarding the extent to which these abuses prevail in their communities; they too have called on. the medical profession to take the necessary steps to stop this permicious practice.

. The editorial concludes (pp. 81-82, infra):

The Board of Trustees of the American Medical Association therefore calls on lead-

That report, set out infra, pp. 75-78, was equally emphatic in condemning the rebate practice.

The "popular periodical with millions of circulation", referred to in the editorial immediately above quoted, was apparently Reader's Digest which, in its January, 1948, issue published a much noticed article by Albert Q. Maisel entitled "Better Vision . . . with a Kickback," 52 Reader's Digest 25. A subsequent article by the same author appeared in May, 1948, Entitled "Medical Kickbacks Can Be Ended," 52 Reader's Digest 58. See also "What Do You Pay For Eyeglasses!", published in 22 Fortune 103 (October 1940), referred to by Dr. Snell, pp. 63-64 infra.

ers of the medical profession in every community in which the Association is represented to act promptly, remembering, however, the necessity for proceeding in due form by the filing of formal charges against physicians known to be participating in such methods, thus offering an opportunity for the presentation of evidence and a suitable hearing so that the innocent may not be harmed but the guilty may be properly exposed and punished.

The infirmity of impression made by the Association's pertinent ethic upon most of the physician witnesses at the hearing (see R. 143) may have been affected by their conceded acceptance of commissions from taxpayers, not disclosed to their patients. In addition, the physicians who were called by the Commissioner in each case were defendants in the Government's anti-trust suit (discussed infra, pp. 47-48) (R. 98-99, 102, 104, 111, 114, 118, 122), and had there been publicly and formally accused of engaging in a similar practice with a wholesale optician. Presumably these physicians have consented to and are now bound by the judgment in the anti-trust suit. (Appendix B, infra, pp. 83-92.) Under these circumatances, the witnesses were hardly disinterested or friendly to the Government's contention here.

3. The kick-back agreements violate state and federal antitrust laws.—As the foregoing material indicates, the illegality of the kick-back

agreements has been a matter of direct concern to the federal government under the anti-trust laws. A complaint based on Section 1 of the Sherman Act filed in 1946 in the Northern District of Illinois against two major optical companies (Respondent's Exhibit T, R. 162-180) charged that such commission or rebate arrangements between a wholesale optical company and physicians were in restraint of trade (pars. 31-41, R. 171-175) and had the effect, inter alia, of fixing arbitrary consumers' prices inflated by the amount of rebates given the defendant doctors (par. 42, R. 175-176). The prayer of the United States that the arrangement be declared unlawful and an injunction be granted both against the defendant optician and the participating doctors (R. 178) was granted by the consent judgment (set out in Appendix B, infra, p. 83) entered on May 16, 1951, in the United States District Court for the Northern District of Illinois, subsequent to the decision below. Both the defendant doctors and the optician defendants were perpetually enjoined from entering into any plan whereby the doctors received from the optician, directly or indirectly, any payment arising out of or connected with dispensing of glasses to any patient of the doctors (p. 87, infra)." Among the defendants to this

¹⁰ Similar consent judgments were entered in the same court on the same day against other opticians and doctors in actions brought by the United States against Bausch & Lomb Optical Company; et al., Civil Action No. 46C 1332;

action, who were presumably bound by the judgment, are many of the doctors to whom petitioners paid rebates (see p. 46, supra).

The statutes of North Carolina (2 General Statutes of North Carolina (1950), Sec. 75-1) and Virginia (Virginia Code of 1950, Annotated, Secs. 59-20 to 59-40), where taxpayers conducted business, governing intrastate commerce, contain language substantially identical with that of the Sherman Act. The arrangements disclosed were plainly unlawful under the federal act and these statutes. As the tribunals below found, the kickbacks tended artificially to increase the cost of glasses. (R. 153, 187.) Indeed, the prices charged by taxpayers to the consumers are necessarily fixed and infleted by the one-third ratio which is paid to the physician. This artificial and fixed one-third exaggeration of the cost to the consumer represents no service whatsoever by the physician to the patient. On the contrary it is part of a plan against the patient's interest. The assertion that' a purchaser of glasses, whose physician is unknown, would be charged the same price as a purchaser, whose physician receives the one-third secret commission, affords no justification, but on the contrary establishes that the arrangement between the physicians and the optician results in artificial stabilization of the price in all cases and

The House of Vision-Belgard-Spero, Inc., et al., Civil Action No. 48C 607; Uhlemann Optical Co. of Illinois, et al., Civil Action No. 48C 608.

bears no relation to services rendered. As this Court has repeatedly held in construing the federal statute, price fixing agreements are unlawful per se. United States v. Trenton Potteries, 273 U. S. 392, 397. See also, United States v. Socony-Vacuum Oil Co., 310 U. S. 150, 218, where this Court further said (p. 221):

Any combination which tampers with price structures is engaged in an unlawful activity. Even though the members of the price-fixing group were in no position to control the market, to the extent that they raised, lowered, or stabilized prices they would be directly interfering with the free play of market forces. * * *

Expenses incurred in violation of statutory policies proscribing price fixing, as here, are properly denied deduction as ordinary and necessary business expenses. Cf. Commissioner v. Longhorn Portland Cement Co.; Universal Atlas Cement Co. v. Commissioner, both cited supra, p. 22.

C. Accordingly, the claimed deductions were properly denied on grounds of public policy

The foregoing discussion makes it clear that the court of appeals' characterization of these secret

The contention that these agreements violated the antitrust laws was not urged in the Tax Court, but was presented to the court below, though not referred to in its opinion. In any event, a decision of a lower tribunal may be sustained on a new legal theory where, as here, no facts not already of record are required for decision. Helvering v. Govern, 302 U. S. 238, 245–246, rehearing denied, 302 U. S. 781; Hormel v. Helvering, 312 U. S. 552, 558.

kick-backs as "unconscionable and reprehensible" (R. 186), is more than justified. Under well-settled principles, the agreements pursuant to which the payments were made were wholly illegal. The payments, moreover, were not merely incidentally related to the illegal schemes; they were its very heart and center. Accordingly, petitioners' bland assertions that they were not "subject to any statute or rule of law designed to deter them" from making the payments here shown, and that the payments "had not the remotest stigma of illegality" (Br. p. 26) are entirely without support.

Nor will it do to assert that petitioners are being "punished * * * by virtue of a rule of private law which is not at all aimed at them" (Petitioners' Br., p. 27). The rules designed to insure faithfulness of fiduciaries are aimed not only at the fiduciary, but at least equally at one who suborns a breach of fiduciary duty (see pp. 35-37, supra). To use an analogy, the giver of a bribe stands in no better light than its taker. And from the point of view of the antitrust laws, also, the companies which pay rebates are at least equally guilty with the doctors who accept them (see pp. 46-49, supra).

Petitioners, moreover, acted deliberately, not inadvertently. As the Tax Court said (R. 154-155):

So far as this record reveals, all the contracts under which these "kickbacks"

were paid were made by petitioners with physician. We think petitioners knew that fact and realized the very high degree of trust and confidence existing between those doctors and their patients. We think petitioners realized that because of that relationship the patients would follow the recommendation of the optician by the doctor, as they did, and that these considerations were what inspired the petitioners, opticians, to make these contracts and the payments, the deduction of which is in controversy.

The Tax Court's finding that the consideration for the 331/3% commissions, which taxpayers paid to them, was the physicians' understanding or agreement to guide or recommend their patients to patronize taxpayers (see also R. 143, 146) is amply supported by the record (R. 9, 17, 22-23, 25-26, 100-101, 109, 116, 120-121). Mr. Lilly testified that in a large number of cases the patient asked his doctor for a recommendation. (R. 17.) Of course, the patient is not required to follow the doctor's recommendation, but by reason of the trust and confidence reposed in the doctor, it is likely that he will follow it (R. 143, 146, 155): That the patients typically so did is further established by the sixty odd thousand dollars kick-backs paid by petitioners to their doctors in each of the taxable vears.

The Tax Court further found that in practi-

cally all instances the patient knew nothing of this arrangement; it was not disclosed to him by his physician or by taxpayers that by prearrangement the third of the price he was charged for the glasses found its way back in his doctor's pockets. (R. 143, 153-155.) The record fully sustains this finding (R. 30, 45, 56, 64), and in any event it is apparently not in dispute. If a patient asked, he was told, but this was a very rare occurrence. (R. 143.) The physician, of course, charged a fee and in practically every instance this was all the compensation which the patient was told or understood the doctor received. (R. 143, 146.)

Accordingly, there can be no doubt that both participants in the agreements knowingly and deliberately intended a breach of the physician's fiduciary duty to his patients. Their recognition of the obvious impropriety of such arrangements is demonstrated, moreover, by the secrecy with which the arrangements were surrounded. only was the patient ignorant of the arrangement but, as the Tax Court found, efforts were made to conceal the agreements from others. The agreements were oral; payments under them were in many instances made in cash and those payments were camouflaged on petitioners' books under the misleading designation of "trade discounts". By no stretch of the imagination can petitioners' illegal action here be described as innocent or inadvertent. Cf. Jerry Rossman Corp.

v. Commissioner, cited supra, p. 22; National Brass Works v. Commissioner, cited supra, p. 22; Pacific Mills v. Commissioner, 17 T. C. No. 80.

In the circumstances of this case, petitioners' argument (Brief, p. 34) that the decision below involves unfair. "retroactive" action, is disingenuous. Cf. Mosser v. Darrow, 341 U. S. 267. and compare dissenting opinion at p. 276. The rules against corruption of fiduciaries and pegging of prices are not innovations. They represent basic standards of honesty. 3 The specific application of those rules to the medical profession had been authoritatively pointed out prior to the taxable years (see pp. 38-46 supra). The rule, denying tax deductions as "ordinary and necessary" to illegal transactions, has long been settled. The Treasury cannot be expected, by express regulation, to cover every form of commercial practice. (See R. 188.) Under these circumstances, the choice between proceeding by general rule or by ruling ad hoc in an individual case lies primarily in the informed discretion of . the administrative agency. Securities Comm'n v. Chenery Corp., 332 U. S. 194, 202-203. Nor does the failure of the Commissioner to deny like deductions for prior years estop him from denying them for these years. Compare Commissioner v. Sunnen, 333 U. S. 591. Indeed, in view of the elements of secrecy and camouflage already referred to, there was little to put him on notice of the true character of such payments.

Accordingly, under the principles discussed in Point I (a), supra, deduction of these expenses will not be allowed. In the language of this Court in the Textile Mills case, supra, 314 U.S. at 328, the payments here made are not "legitimate business expenses"; on the contrary they arise from that family of contracts to which the law has given no sanction." The rules prohibiting enforcement of such contracts, and the policies which they violate, are at least as well settled and clearly defined as those against the lobbying activities involved in the Textile Mills case, or the payments for personal influence involved as in the Rugel, Harden M. Loan Co., Easton Tractor & Equipment Co., and Nicholson cases, all cited supra, pp. 19-21, or the payments for referring a client to an abortionist involved in the Giubbini case cited supra, p. 21, or those in other cases in which deductions have been denied on public policy grounds.

Bateman v. Commissioner, 34 B. T. A. 351, 367-368, cited by the dissenting Tax Court judge (R. 160) and much relied upon by taxpayers (Br. 29, 33), approving deduction of payments in the nature of "tips" to traffic agents and railroad employees, is clearly distinguishable factually, for in contrast to the present case the Board explicitly held that (p. 367):

There is no evidence showing that the practice was corrupt or tended to corrupt or that it was detrimental to the railroads.

Nor are petitioners aided by cases such as Anderson v. Commissioner, 81 F. 2d 457 (C. A. 10) and Helvering v. Hampton, 79 F. 2d 358 (C. A. 9) (Pet. Br., pp. 19-20) permitting deduction for civil damages paid individuals in reparation for tortious conduct. There is a sharp difference between payments which are illegal and contrary to public policy and those which constitute restitution for damages caused by prior tortious conduct. To permit the deduction of reparation payments subverts no public interest. But, as the Textile Mills case clearly holds, to sanction and facilitate illegal contracts by permitting tax deduction of payments made pursuant to them is plainly offensive to the public interest.

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Even apart from considerations of public policy, petitioners have not satisfied their burden of establishing that such kick-back payments were "ordinary and necessary"

Petitioners' assumption (Br. 14) that the Tax Court and the court below "conceded that the payments to the physicians satisfied the requirements of Section 23 (a) (1) (A)" and denied the deduction only on "non-statutory" grounds of public policy, is erroneous in two respects. In the first place, as we have seen in Point I, supra the construction of the statute as requiring denial of business expense deductions for payments which offend public policy is well settled. In the second place, petitioners have not, in any

event, satisfied their burden of establishing that the payments here shown were "ordinary" or "necessary" in any sense of those words. On the contrary, petitioners' contention that the secret kick backs were normal and appropriate in the optician's trade is totally without support in any finding of the Tax Court or the court below. The Tax Court and the court below held that the kickback practice was corrupt and neither ordinary nor necessary (R. 154-155, 158, 184, 186, 188). The facts that patients were not informed or aware of the practice, and that petitioners themselves camouflaged the payments on their books, demonstrate the extraordinary nature of those payments.

It is true that some withesses before the Tax Court, all of whom kad engaged themselves in the kick-back practice, testified that that practice was in common use in the communities in which petitioners operated. But there is nothing in the record, or in materials of which this Court can take judicial notice, to establish that it was a generally accepted practice in the optical business. On the contrary, the materials already cited from American Medical Association sources show that reputable doctors have always refused to engage in such a practice and, while referring their patients to optical companies for the manufacture and fitting of eveglasses, have refused to accept any rebates or commissions from those (See pp. 38-46, supra, and especially companies.

Appendix, pp. 68, 71, infra.) The record discloses that petitioners' competitor in Greensboro, North Carolina, although following the practice for a while, has abandoned it. And, presumably, as a result of the antitrust actions of the Federal Government (supra, pp. 46-49) the principal optical companies of the United States have now abandoned it. Beyond this, it may be assumed that in North Carolina, in which state petitioners principally operate, no optical company now engages in the practice, since it has been expressly declared illegal by statute:

As this Court declared in Welch v. Helvering, 290 U.S. 111, 114, an expense may be deemed ordinary and necessary only if it conforms to the "norms of conduct" of the business community. "The standard set up by the statute is not a rule of law it is rather a way of life. Life in all its fullness must supply the answer to the riddle." Id. at 115. The test is not whether the practice was engaged in by some opticians, or even whether it was somewhat prevalent in the optician's trade. The test is whether it conforms to the standards of the business community as a whole. Surely, this making of secret payments in corruption of a professional relationship of the utmost confidence, this greasing of palms (R. 156), is not normal in the business life of any American community: only abysmal cynicism would pretend to the contrary. Here both the fact finder (R. 156) and the court below (R. 186) have unqualifiedly repudiated such a notion.

Thus this Court has here, in contrast to the situation in the *Heininger* case, supra, 320 U. S. at p. 470, the benefit of the independent judgment of the Tax Court, which denied these deductions claimed by taxpayers upon its own interpretation of the words "ordinary and necessary" as applied to its findings of fact. We submit that its informed judgment that these payments were neither "ordinary" nor "necessary" by any normal business standard should be sustained.

CONCLUSION

The decision of the Court of Appeals is correct and should be affirmed.

Respectfully submitted.

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NOVEMBER 1951.

APPENDIX A

REPRINTS FROM PROFESSIONAL MEDICAL PUBLICATIONS

I

Principles of Medical Ethics of the American Medical Association (1943):

CHAPTER I

In General

The Physician's Responsibility

Section 1. A profession has for its prime object the service it can render to humanity; reward or financial gain should be a subordinate consideration. The practice of medicine is a profession. In choosing this profession an individual assumes an obligation to conduct himself in accord with its ideals. (P. 3.)

CHAPTER III

The Duties of Physicians to Each Other and to the Profession at Large

ARTICLE I. Duties to the Profession

Uphold Honor of Profession

Section 1. The obligation assumed on entering the profession requires the physician to comport

himself as a gentleman and demands that he use every honorable means to uphold the dignity and honor of his vocation, to exalt its standards and to extend its sphere of usefulness. * * * (P. 6.)

Deportment

SEC. 3. A physician should be "an upright man, instructed in the art of healing." Consequently, he must keep himself pure in character and conform to a high standard of morals, and must be diligent and conscientious in his studies. * * * (P. 7.)

· Patents and Perquisites

SEC. 5. It is unprofessional to receive remuneration from patents or copyrights on surgical instruments, appliances, medicines, foods, methods or procedures. It is equally unprofessional by ownership or control of patents or copyrights either to retard or to inhibit research or to restrict the benefit to patients or to the public to be derived therefrom. It is unprofessional to accept rebates on prescriptions or appliances, or perquisites from attendants who aid in the care of patients. (P. 8.)

Safeguarding the Profession

SEC. 7. Physicians should expose without fear or favor, before the proper medical or legal tri-

bunals, corrupt or dishonest conduct of members of the profession. * * * (P. 9.)

ARTICLE VI. Compensation

Commissions

SEC. 4. When a patient is referred by one physician to another for consultation or for treatment, whether the physician in charge accompanies the patient or not, it is unethical to give or to receive a commission by whatever term it may be called or under any guise or pretext whatsoever. (P. 21.)

Direct Profit to Lay Groups

SEC. 5. It is unprofessional for a physician to dispose of his professional attainments or services to any lay body, organization, group or individual, by whatever name called, or however organized, under terms or conditions which permit a direct profit from the fees, salary or compensation received to accrue to the lay body or individual employing him. Such a procedure is beneath the dignity of professional practice, is unfair competition with the profession at large, is harmful alike to the profession of medicine and the welfare of the people, and is against sound public policy. (P. 21.)

Conclusion

* In a word, it is incumbent on the physician that under all conditions, his bearing toward patients, the public and fellow practitioners should be characterized by a gentlemanly deportment and that he constantly should behave toward others as he desires them to deal with him. Finally; these principles are primarily for the good of the public, and their enforcement should be conducted in such a manner as shall deserve and receive the endorsement of the community.

II

Principles of Medical Ethics of the American Medical Association (1949):

CHAPTER I

General Principles

Patents, Commissions, Rebates and Secret Remedies

SEC. 6. ** * The acceptance of rebates on prescriptions or appliances, or of commissions from attendants who aid in the care of patients is unethical. An ethical physician does not engage in barter or trade in the appliances, devices or remedies prescribed for patients, but limits the sources of his professional income to professional services rendered the patient. He should receive his remunifration for professional services rendered only in the amount of his fee specifically announced to his patient at the time the service

is rendered or in the form of a subsequent statement, and he should not accept additional compensation secretly or openly, directly or indirectly, from any other source.

o III

117 The Journal of the American Medical Association 497–499 (August 16, 1941):

Some Principles of Medical Ethics Applied to the Practice of Ophthalmology' Chairman's address, Albert C. Snell, M. D., Rochester, N. Y.

Since my election to the chairmanship of this section, I have received considerable correspondence with reference to certain questionable practices of ophthalmologists in the dispensing of ophthalmic lenses. Also there has appeared in a high class nationally distributed magazine a critical and informative article setting forth principally those practices which are no credit to the profession. The time, therefore, seems opportune to examine some common methods of practices and to compare them with the historically established ethical principles of our profession.

The principles of medical ethics are just as binding on those practicing ophthalmology as they are on all other members of the medical profession. There are, however, some situations which are peculiar to the special practice of ophthalmology. These situations present unusual temptations to violate our best ethical

Read before the Section on Ophthalmology at the Ninety-Second Annual Session of the American Medical Association, Cleveland, June 4, 1941.

standards. It is my purpose in this address to bring anew to your attention some of these principles of ethics and apply them to some common methods of practice in order that these methods may be analyzed. I hope that each individual ophthalmologist will compare his method of practice with that type of ethical conduct which is de-

manded by the medical profession.

It is much to be desired that both individual ophthalmologists and organized groups will strive to correct any unethical conduct that may be found to prevail. Some forms of practice not only are bringing disrespect and dishonor to the profession but much positive harm as well. When ethical principles and ideals of the medical profession are not respected by even a small group of ophthalmologists, opprobrium is placed on the entire profession, the ethical and unethical alike. Every individual ophthalmologist becomes the object of derision. This is illustrated by the article mentioned, which sets forth information of certain under-cover, questionable trade practices existing between dispensing opticians and ophthalmologists. For example, the article informs the public that the dispensing optician "may sell direct to the patient, under an ar-rangement which would shock that patient rudely if he understood it.' The article states further that the patient may have been deluded into thinking that the wholesale price is charged by the dispenser, whereas a full retail price is colelected "which he later splits, on the quiet, with your physician." This article also states that "kick-back," "furtive fee-splitting" is not exceptional: that the ophthalmologist pockets a reThis practice sometimes is given the softer and more subtle term of a "differential." All these forms of participation in the profits from the supplying of ophthalmic lenses and mountings are usually done without the knowledge of the patient and without rendering any special service to the patient. These are some of the grounds on which ophthalmologists are indicted not only by the public buff also by the medical profession. What is your answer to this indictment? Shady and secret methods of rebating which are by no means uncommon can be kept in the dark no longer.

Fundamental Principles of Ethical Conduct

Let me review a few fundamental principles to which all physicians are obligated in order that a foundation may be laid for the proper answer to this indictment and that all may comprehend the approved standard of ethical conduct.

In the booklet published by the American Medical Association the fundamental principle which should activate the relation between the physician and his patients is stated thus:

A profession has for its prime object the service it can render to humanity; reward or financial gain should be a subordinate consideration.

The question of proper ethical conduct can always be answered by applying this principle. Does the possibility of financial and selfish gain predominate, or do we consider the interest of the

Principles of Medical Ethics of the American Medical Association, Chicago, American Medical Association, 1940.

Principles of Medical Ethics, p. 3:

patient as most important? I commend the reading of this entire booklet to all ophthalmologists. It briefly and clearly sets forth the ideals which should dominate the physician's conduct and his obligations to the profession, to the public and to patients. I wish to call attention to only a few of these specific obligations which are set forth in this booklet which should be fulfilled by all ophthalmologists. The first is:

The obligation assumed on entering the profession requires the physician to comport himself as a gentleman and demands that he use every honorable means to uphold the dignity and honor of his vocation, to exalt, its standards and to extend its sphere of usefulness.

The second obligation is a rule of conduct relating to rebates. It is stated thus:

It is unprofessional to accept relates on prescriptions or appliances, or perquisites from attendants who aid in the care of patients.

The third obligation, which relates to "profits to lay groups" is stated thus:

It is unprofessional for a physician to dispose of his professional attainments or services to any lay body, organization, group or individual, by whatever name called, or however organized, under terms or conditions which permit a direct profit from the fees, salary or compensation received to accrue to the lay body or individual employing him. Such a procedure

Principles of Medical Ethics, p. 6.

⁵ Principles of Medical Ethics, p. 8.

Principles of Medical Ethics, p. 21.

is beneath the dignity of professional practice, is unfair competition with the profession at large, is harmful alike to the profession of medicine and the welfare of the people, and is against sound public policy.

And finally

the duty of the physician to his patients, to other members of the profession and . . . as well as to . . . the public . . .

is stated thus:

It is incumbent on the physician that under all conditions, his bearing toward patients, the public and fellow practitioners should be characterized by a gentlemanly deportment and that he constantly should behave toward others as ne desires them to deal with him. Finally, these principles are primarily for the good of the public, and their enforcement should be conducted in such a manner as shall deserve and receive the endorsement of the community.

Let me call your attention also to the following resolutions, which were adopted by the Section on Ophthalmology of the American Medical Association at the Chicago session in June 1924. These, however, were not presented to the House of Delegates.

Resolved, That it is the sense of the Section on Ophthalmology of the American Medical Association that we deprecate the selling of glasses by the ophthalmologist to his patients, in communities where the services of reliable dispensing opticians are obtainable; and

7 Principles of Medical Ethics, p. 24.

Resolved, That the acceptance of commissions or considerations, either directly or indirectly, from opticians and optical houses, from the sale of glasses is absolutely contrary to all our standards of medical ethics and is just as reprehensible as the splitting of fees.

These principles of ethics and the resolutions adopted by this section present the obligations which the profession regards as the minimum ethical standards of practice for ophthalmologists. From the information which I have been able to gather I fear that these standards are more "honor'd in the breach than in the observance."

. The situation which is peculiar to ophthalmologists consists in the fact that the correction of errors of refraction constitutes a large percentage of his practice from 60 to 90 per cent; and ophthalmic lenses and their mountings must be supplied and properly fitted to each individual when a correction is prescribed. This requires some form of commercial relationship with those nonmedical men who render this service. Another situation peculiar to the practice of ophthalmology is competition with optometrists in the service of correcting errors of refraction. many communities the fee of the ophthalmologist for making the ocular examination, including that of refraction, is less than the profit made by one who furnishes the prescribed glasses. Very often too, when the prescription falls into the hands of the optometrist the patient likewise falls into his hands. The degree of cooperation between ophthalmologist and optometrist leaves. very much to be desired. The advertising and

the activities of the publicity agents of the optometrists place at a disadvantage the ethical ophthalmologist who does not, will not and should not employ these methods to secure favor with a price conscious public, easily influenced by the wiles of the advertiser.

Methods of Supplying Glasses

Let us now analyze the methods, commonly employed, by which glasses are supplied and then point out briefly the ethical principles involved in the use of each method. There are at least six different methods for supplying the correcting

glasses, which are as follows:

1: The first method is that in which the ophthalmologist gives the prescription for the lenses directly to the patient, who is instructed to have it filled by any reliable optician of his own choice. Should the patient request the ophthalmologist to recommend an optician, such recommendation is usually made. It is customary for the ophthalmologist to make an inspection after the prescription is filled. For the entire service of supplying a prescription and inspection the ophthalmologist receives a single fee and no other remuneration either directly or indirectly. In the use of this method he does not accept any rebate, "kickback" or any part in the profit from the glasses, provided.

2. By the second method the ophthalmologist personally furnishes the glasses. He does this either by means of an optician's laboratory, connected with his office, or by having the prescription filled and mounted by a dispensing or jobbing optician, the completed job being delivered to the

ophthalmologist who makes final inspection and adjustment, the ophthalmologist charging and collecting the prevailing retail price of the glasses in addition to his fee for examination. This is a direct and open and ethical transaction between

doctor and patient.

3. By the third method the prescription is filled and the mounting completely fitted by a wholesale dispensing optician, who charges a nominal fee for the extra service of adjustment of mountings and collects the prevailing retail price for the completed work. This leaves a differential in cost between the wholesale price plus service charge and the retail price, and this differential—a profit—is credited to the ophthalmologist issuing the prescription. This method may or may not be known by the patient.

4. By the fourth method the ophthalmologist sends the patient to some chosen optician, who completes the entire work of filling the prescription, mounting, adjusting and collecting the full retail price, returning to the ophthalmologist a specified rebate, which is done without the knowledge of the patient. By some the prescription is not given to the patient but is delivered to the

optician so that none may go astray.

5. The fifth method is one in which ophthalmologists have a partial or complete ownership in an optical dispensing store, which at times is designated by the more subtle name of laboratory. By this method the ophthalmologist has a direct interest in the profits from sales connected with his prescriptions. The financial interest in such stores is generally not known to the patients who patronize such stores on advice of the ophthal-

mologist.

6. There is a sixth method. There are a few instances in which a physician with little knowledge of ophthalmology contracts for his services on a salary or on a percentage basis to some retail establishment where both the examination and the sales are conducted.

Comment

The first method is the ideal, ethical one; its employment is in harmony with the resolution of this. section. It removes the possibility of any selfish interest or bias in the transaction of supplying glasses. This is the highest ethical form of practice and is followed by the leading ophthalmologists in the United States.

The ethics of the second method hinges on the question, under certain given circumstances of location or of availability of dependable opticians, whether adequate optician's services can be obtained. That service which has the best interest of the patient in mind is the one which should be employed; in many localities the ophthalmologist must perform the fitting and adjusting services usually rendered by the retail or dispensing optician. There is nothing unethical about this form of practice if all financial transactions are open and understood by the patient. And there can be nothing unethical in charging the established retail price for the quality of the glasses supplied, when the services of fitting, checking · and adjusting are performed by the ophthalmologist. He also assumes the responsibility of the financial transactions.

The third method, the one in which the whole-sale dispenser furnishes the glasses and makes some nominal charge above the wholesale price, performs the service of adjustment, inspection and collection but credits the ophthalmologist with a differential, is open to criticism, especially when no additional service is rendered for the differential, which is, of course, a rebate. And this practice is particularly reprehensible when it is done secretly.

There can, of course, be no justification whatever for the receiving of a percentage rebate for glasses which are furnished by opticians who provide all the services connected with the supplying of glasses. This practice violates every ethical medical principle of practice. Under these circumstances the patient either receives an inferior quality of product or an inferior optical service.

The outright or partial interest in any retail optical store is an indirect method of receiving rebates, and the best ethical traditions of the profession are violated when ophthalmologists yield to this temptation to make a profit on ophthalmic

supplies.

The practice of selling one's services to some lay body is a direct violation of the physician's obligation to the profession, as I have shown in the quotation from the Principles of Medical Ethics. This practice fortunately is seldom followed. No self-respecting ophthalmologist should be guilty of this unethical practice.

It is a fundamental duty of the ophthalmologist to give to his patients an unselfish unbiased and unhampered service—the best advice which his experience and knowledge dictate. It is very

questionable whether such service can be rendered without some degree of prejudice, perhaps unconsciously, by an ophthalmologist who has a financial interest in the commercial side of supplying the equipment. As far as refractive problems are concerned, patients consult the ophthalmologist not primarily to get a pair of lenses but to find out whether or not there is need for them. The answer to that problem should be answered without any bias.

It seems to me that the crux of unethical practices lies primarily in some secret form of rebate, differential or kick-back—to some furtive participation in the profits connected with the supplying of lenses and their mountings, which participation is done without the knowledge of the patient. As a consequence of this method of practice, patients are compelled to pay for services which are not rendered either by the ophthalmologist or by the optician. Evidently this practice does not consider the best interest of the patient.

When an adequate and proper fee is made for the professional services rendered, the ophthalmologist is not ethically entitled to some additional fee from the sale of the glasses. When any rebate method is practiced, by whatever name it is designated, which method requires the optician to split the profits with the ophthalmologist, it is probable either than an inferior quality of ophthalmic goods is supplied or that the optician's service is lacking in high standard. All rebates are a form of fee splitting which cannot be defended on any ethical ground. There can be no justification for trading on the confidence of the patient openly or secretly, but the secret practice is the more reprehensible. These forms of unethical conduct are emphatically condemned by the medical profession, and those who practice them are bringing disrespect, derision and dis-

honor to the profession.

In an address delivered at a recent meeting of the Medical Society of the County of Monroe in New York State, Dr. Van Etten, President of the American Medical Association, said that organized medicine had always upheld the highest ethical standards and "The parent organization has never sold us down the river because of any form of commercial or legislative pressure." Surely the Section on Ophthalmology of the parent organization will not be the exception to this ethical history. No ophthalmologist should be guilty of participation in the secret distribution of profits in the supplying of glasses, nor should he be guilty of trading on the confidence of his patients. Every ophthalmologist should conduct his practice and his relationship with lay bodies so that he will serve the best interests of the public, the patients and the profession. Only in this way will he help to remove the indictment against ophthalmologists and help to maintain the good repute of our honored profession at its historic ethical standard.

53 South Fitzhugh Street.

IV

EDITORIALS.

131 The Journal of the American Medical Association 1128 (August 3, 1946):

Indictment of Optical Firms and Ophthalmologists Under Sherman Act

Elsewhere in this issue (page 1138) appears a condensation of two complaints filed by the United States through the Department of Justice charging optical wholesalers and ophthalmologists with violating the Sherman Act by fixing prices on spectacles through rebating to the ophthalmologists approximately one half of the total price paid by their patients for eyeglasses. The Department of Justice adopted the unusual device by selecting certain physicians as representative of the entire class of physicians securing rebates as defendants in the suit. Attorney General Tom C. Clark said in connection with the filing of the suits that "the department is informed that the rebating practice is industry wide and it is presently expediting its investigation of all wholesale dispensers in the optical field. If investigation discloses similar practices, additional suits will be filed as quickly as possible." The newspaper release made by the Department of Justice states that some individual physicians receive as much as \$40,000 annually in rebates. The actual figures cited in the complaint indicate instances in which a Chicago patient was charged \$14 for lenses, the optician receiving \$2.50 and the physician \$11.50; an instance in which a patient paid \$25 for lenses, the company

receiving \$10.80 and the physician \$14.20. A Dallas patient paid \$21 for lenses, which was divided approximately equally between the optician and the physician, and an Oklahoma City patient paid \$22, the manufacturer receiving \$9.10 and the physician \$1290. Similar figures are available for prescriptions filed in Madison, Wis., Minneapolis and Denver. Moreover, the actual cumulative figures indicate that one group of physicians in Iowa received more than \$42,000. One physician in a small town in Texas received almost \$15,000, a sum equaled by physicians in Minneapolis, Waterloo, Iowa, Rockford, Ill., and other small communities.

The position of the American Medical Association on this practice has been stated definitely on several occasions. In 1924 the Section on Ophthalmology of the American Medical Association adopted a resolution stating:

> Resolved, That the acceptance of commissions or considerations, either directly or indirectly, from opticians and optical houses in the sale of glasses is absolutely contrary to all our standards of medical ethics and is just as reprehensible as the splitting of fees.

That resolution was not presented to the House of Delegates and was therefore an action of the section but not an action of the American Medical Association. In 1942 a resolution was presented to the House of Delegates to the effect that

of the American Medical Association or its component branches to refer patients to commercial organizations, laboratories or other physicians who advertise to the pubwho employ steerers or cappers or who offer to pay rebates or commissions or in any other manner violate the principles of Medical Ethics of the American Medical Association or its component branches.

This resolution was referred to a reference committee, which brought back a revised resolution to the House of Delegates. The following revised resolution was adopted:

Resolutions on Rebates: Your reference committee has given very serious consideration to these resolutions. It is the opinion of your reference committee that the practices referred to in the resolutions are beneath the dignity of a learned profession, are basically dishonest and are a violation of the Principles of Medical Ethics. Your reference committee therefore recommends that the following substitute-resolutions be adopted:

Whereas, It has been brought to the attention of the House of Delegates that the unscrupulous practice of rebates to physicians is being engaged in by various commercial organizations, laboratories, supply houses and in some professional relationships between certain physicians; and

Whereas, All such practices are clearly in violation of the Principles of Medical Ethics; therefore be it

Resolved, That the House of Delegates of the American Medical Association express stern disapproval of the practice by any of the members of its component societies of referring patients to commercial organizations, laboratories or other physicians who advertise to the public and

others than the medical profession, who employ so-called steerers or cappers or who pay, or offer to pay, rebates or commissions in any guise whatsoever, or who in any other manner violate the Principles of Medical Ethics of the American Medical Association; and be it further

Resolved, That any member violating these resolutions be subject to such disciplinary action as is deemed advisable by the county society in which such physician holds membership; and be it further

holds membership; and be it further. Resolved, That the Secretary of the American Medical Association be instructed to send a copy of these resolutions to each state and county society accompanied by a letter to the secretary of each setting forth that all such unethical practices are disreputable and unscrupulous and, if not controlled, may soon besmirch the reputation of the entire medical profession.

V

136 Journal of the American Medical Association 176-177 (January 17, 1948):

Repates, Kickbacks, Commissions and Medical Ethics

The pride of medicine as a profession has always been its freedom from the taint of barter and trade in the sick patient. Physicians must give their wholehearted devotion to the care of the patient; no other objective must be given precedence over considerations of the patient's need. Nevertheless, the charge is made that some physicians have forgotten the ethical principles that prevail in the relationship between doctor

and patient and have selected the surgeon willing to make the greatest division of fees rather than the one best suited to perform the operation. Ophthalmologists have sent the patient for lenses. to opticians who returned a proportion of the fee rather than to the optician who rendered the highest quality of optical service. Occasionally orthopedic surgeons and others who utilize the work of the maker of braces, splints and elastic bandages have been willing to accept commissions from such manufacturers and have designated the procurement of these accessories to the agency offering the largest commission rather than to the one most painstaking in production and most reasonable in price. From time to time criticism has been leveled against pharmacists who have offered commissions to physicians on the prescriptions sent to them and to the physicians who have accepted such commissions. Wherever barter and trade have insinuated their insidious and evil aspects into the practice of medicine, the quality of the service has depreciated. The morals of the physicians and the commercial agencies that deal in these unwholesome profits in this marketing of medical care have already deteriorated.

From the beginning of its entrance on the medical scene, the American Medical Association has fought this menace to the quality of medical service and to the good repute of medical practice. Resolutions have been passed by the official bodies of the Association unequivocally condemning such practices. The Judicial Council has repeatedly urged the expulsion or other action against physicians proved to have participated in such procedures. The leaders of surgery, ophthal-

mology, orthopedic surgery and pharmacy have been unanimous in pointing out the extent to which such commercial considerations may break down the good repute of the specialties concerned. The American College of Surgeons adopted an oath to be taken by its fellows to the effect that they would not participate in the secret division of fees. The Principles of Ethics of the American Medical Association have declared the unethical character of such divisions—direct or indirect.

Now the development of greater complexity in medical practice and in medical relationships has introduced new factors into this problem of barter and trade. The development of roentgenology as an important medical specialty and the establishment of clinical pathologic laboratories to which physicians send patients for the making of highly technical and often costly tests have introduced new sources of rebates, kickbacks and commissions. In some communities means have been proposed for evading the condemnation of medical organizations and societies through the establishment of corporations, cooperative laboratories and roentgenologic offices of multiple ownership.

As might have been anticipated, the ultimate development was recognition by governmental agencies of the fact that the unprotected public was being exploited by such methods. The first warning and one of tremendous significance was the indictment by the Department of Justice of two manufacturing optical agencies and of a considerable number of ophthalmologists who participated in a plan which took hundreds of thousands of dollars from unknowing patients. A full

report appeared in The Journal of the American Medical Association when the Department of Justice took this action during 1946. A popular periodical with millions of circulation has called on the medical profession to cleanse itself as it has repeatedly cleaned its own house in the past. The House of Delegates asked the Secretary of the American Medical Association to call the situation to the attention of every state and county medical society in the nation and to urge on these societies the initiation of the necessary steps toward ridding medical practice of these parasites. The Better Business Bureaus in several large communities, notably Los Angeles, have begunda campaign of enlightenment of the public regarding the extent to which these abuses prevail in their communities; they too have called on the medical profession to take the necessary steps to stop this pernicious practice.

The housecleaning has been too long delayed. Biology has proved that any living organism that tries to maintain itself in the presence of fifth invariably dies. The Board of Trustees of the American Medical Association therefore calls on leaders of the medical profession in every community in which the Association is represented to act promptly, remembering, however, the necessity for proceeding in due form by the filing of formal charges against physicians known to be participating in such methods, thus offering an opportunity for the presentation of evidence and a suitable hearing so that the innocent may not be harmed but the guilty may be properly exposed

and punished.

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APPENDIX B

In the District Court of the United States for the Northern District of Illinois, Eastern Division

Civil Action No. 46 C 1333

UNITED STATES OF AMERICA, PLAINTIFF

v. 6

AMERICAN OPTICAL COMPANY, ET AL., DEFENDANTS

FINAL JUDGMENT

Plaintiff, United States of America, filed its complaint herein on July 23, 1946, and filed an amendment thereto on October 28, 1946. Thereafter, the corporate defendants and the defendant individual doctors appeared and filed their answers and amended answers to the amended complaint, denying the substantive allegations thereof and any violations of law.

Subsequent to the filing of the compaint, the corporate defendants, without prior notice to the plaintiff or the Court, discontinued dispensing at all of their branches where such business was carried on and, in connection with such discontinuance in certain locations, transferred the dispensing businesses and/or assets relating thereto in such locations to defendant transferees, who have been and are on the date of entry of this judgment engaged in dispensing on their own behalf.

On September 18, 1950, leave of Court having first been obtained, plaintiff filed a supplemental

complaint relating to such transfers to the defendant transferees.

On February 26, 1948, the Court entered an order directing the defendant class doctors whose names were set forth in an exhibit attached to said order, to appear and show cause why such doctors should not be bound by any judgment entered in this case. (A copy of such order, omitting the list of names, is attached hereto as Exhibit 1.) Exhibit 2, also attached hereto, sets forth the names of each defendant class doctor who either received mailing and service of the aforesaid orders and failed to show cause why he should not be bound by any judgment entered in this case, or who submitted himself to the jurisdiction of this Court and agreed to be bound by such judgment, whether after trial or by consent of the parties.

Each of the corporate defendants defendant individual doctors, and defendant transferees hereby consents to the entry of this final judgment. The consent of each defendant individual doctor is made both as an individual and as a representative of the defendant class doctors as hereinafter defined.

Now, therefore, upon such consents, no testimony having been taken, and without any finding or adjudication of fact or as to past specific transactions, or any admission by reason of such consents or this judgment, excepting only the statements hereinabove set forth, which are made solely for the purpose of this proceeding; it is hereby

Ordered, adjudged and decreed as follows:

I. This Court has jurisdiction of the subject

matter and of all defendants named in the complaint, as amended, including the defendant class doctors named in Exhibit-2 and the defendant transferees named in the supplemental complaint herein; any agreement, understanding and concert of action, whether written or oral, express or implied, of the type charged in the complaint, involving payment by any corporate defendant, directly or indirectly, to any of the defendant individual doctors or to defendant class doctors, or to any agent, representative, employee or designee of any such doctor, of the whole or any part of the purchase price of oplithalmic goods collected by any such corporate defendant whether or not as agent or purported agent of such doctor) from any one or more patients of any such doctor, and whether in the form of, or described or regarded as a rebate, credit, credit balance, gift, dividend, or participation or share in profits, or otherwise, is hereby adjudged to be in violation of Section I of the Sherman Act; and the complaint, as amended, and the supplemental complaint state a cause of action under Section 1 of the Sherman Act (15 U. S. C. Sec. 1), upon which relief may be granted.

II. Wherever used in this judgment:

(a) "Corporate defendants" means American Optical Company, an association, American Optical Company, a corporation, and their respective successors, assigns, officers, directors, agents, employees and representatives, and each and every other person acting or claiming to act under, through, or for such defendant, excluding, however, the defendant individual doctors, the defendant class doctors and the de-

fendant transferees, as hereinafter respec-

tively defined.

(b) "Defendant individual doctors" means those oculists named in the complaint as individual defendants and as representatives of the defendant class doctors and each person acting or claiming to act under, through, or for any such defendant individual doctor.

(c) "Defendant class doctors" means those oculists whose names are listed in Exhibit 2 attached hereto, and each person acting, or claiming to act, under, through,

or for any such doctor.

(d) "Defendant transferees" means those persons who are named as defendants in the supplemental complaint herein and each person acting or claiming to act under, through, or for any such transferee.

(e) "Person" means an individual, proprietorship, partnership, association, joint stock company, business trust, corporation, or any other business organization or en-

(f) "Opl thalmic goods" means ophthalmic lenses, lens blanks, spectacle frames, mountings, eyeglasses, spectacles, and component parts or combinations of any of these articles sold or offered for sale within the United States, its territories and possessions, and as so defined does not include sunglasses or industrial safety equipment not containing lenses ground to prescription.

(g) "Dispensing" means the sale within the United States, its territories and possessions to consumers, of ophthalmic goods, particularly of spectacles and parts thereof, and of repair parts and services in connection therewith, and/or the measurement of facial characteristics for spectacles and the fitting and ajustment of such specta-

cles to the face.

(h) "Dispenser" means one who engages in dispensing. The term shall not be deemed to apply to a refractionist who engages in dispensing in his own professional offices (either himself or through a bona fide employee) to his own patients only.

(i) "Consumer" means any person who wears spectacles, or any patient for whom spectacles have been prescribed by a refrac-

tionist.

III. Each defendant individual doctor and defendant class doctor is hereby perpetually enjoined:

(a) From accepting, directly or indirectly, or designating any other person to thus accept, from any dispenser (whether such dispenser acts or purports to act as an agent of the doctor, or otherwise), any payment arising out of or connected with dispensing to any patient of such defendant doctor, whether such payment is in the form of, or is described or regarded as a rebate, credit, credit balance, gift, dividend, participation in or share in profits, or otherwise;

(b) Entering into or participating in any plan, arrangement, or scheme whereby said defendant doctor receircs from any dispenser (whether such dispenser acts or purports to act as agent of the doctor, or otherwise) directly or indirectly in any form (including any of the forms and methods referred to above) any payment arising out of or connected with dispensing to any patient of such defendant doctor.

IV. Each of the corporate defendants and each of the defendant transferees is hereby perpetually enjoined from making, directly or indirectly, any payment to any refractionist (including any oculist), or any agent, representative, employee or designee of any refractionist, arising out of or connected with dispensing, whether or not such payment is in the form of, or is described or regarded as, a rebate, credit, credit balance, gift, dividend, participation in or share in profits, or otherwise; and whether such payment constitutes an individual transaction, or is part of any plan or program.

V. Each of the corporate defendants is hereby

perpetually enjoined from:

) Enforcing, performing, or entering into any agreement, contract, or under-standing with any defendant transferee by which such defendant transferee agrees to purchase from any corporate defendant the defendant transferee's requirements or substantial requirements of any ophthalmic goods, supplies, or equipment for any designated period of time, or any specified volume of such goods, supplies, or equipment beyond those needed by the defendant transferee for his current business requirements and requested by him in the exercise of his own free choice; or agrees in advance to place orders for any shop work to be done by a corporate defendant.

(b) Enforcing, performing, or entering into any contracts, agreements, or understandings covering, or issuing any schedules fixing, or systematically suggesting, the consumer prices, terms, or conditions

of sale on which any defendant transferee

shall sell ophthalmic goods.

(c) Enforcing, performing, or entering into any contract, agreement, or understanding with any defendant transferee dictating, prescribing, or suggesting to any such defendant transferee any arrangement restraining or limiting such defendant transferee as to the territory in which he shall operate or do business, or restraining or limiting the type of business such defendant transferee may engage in or enter into.

(d) Dominating, controlling, or interfering with, or attempting to dominate, control, or interfere with, the prchasing, financial, promotional, or other business policies, practices, operation, management, expansion or other activities of any such

defendant transferee.

(e) Enforcing, performing, or entering into any agreement, contract, or understanding under which any corporate defendant grants any credit, discount, rebate, or allowance, based on a percentage or other proportion of the amount of ophthalmic merchandise purchased from such defendant, which credit, discount, rebate, or allowance is applied, or to be applied, in whole or in part, to reduce indebtedness incurred by any defendant transferee in connection with the acquisition from any corporate defendant of dispensing assets, or the dispensing business, of one or more of the branches of any corporate defendant.

VI. Each of the corporate defendants is hereby enjoined for a period of ten years from the date of entry of this judgment from engaging in the business of dispensing, and from acquiring or

holding any ownership interest, whether through the purchase or ownership of assets, stock or otherwise, in any person who engages in such.

business of dispensing.

VII. The corporate defendants, each of the defendant individual and class doctors, and each of the defendant transferees, are hereby perpetually enjoined from entering into any agreement, understanding or concert of action with any other person or persons, fixing or attempting to fix the consumer price to be charged for ophthalmic goods or services, and from dictating, prescribing, controlling or interfering with, or attempting to dictate, prescribe, control, or interfere with the consumer prices charged or to be charged by any other person or persons for such ophthalmic goods or services; provided, however, that nothing contained in this judgment shall be deemed to prevent or restrain any of the defendants after the expiration of the injunction contained in Section VI hereof from making such suggestions or making and enforcing such agreements as to prices as may then be lawful.

VIII. The plaintiff shall mail a copy of this judgment to each member of the defendant class doctors whose name is set forth in Exhibit 2, attached hereto and made a part hereof. Such mailing shall be by franked envelope to the last known address of each of such defendant class doctors, and the plaintiff, after making such mailing, shall file an affidavit of mailing with the Clerk of this Court. The plaintiff may transmit with such mailing a letter, in a form to be approved by the Court, covering the transmission

of such judgment and explaining the application of the judgment to the doctor.

IX. For the purpose of securing compliance with this judgment, and for no other purpose, duly authorized representatives of the Department of Justice shall upon written request of the Attorney General or an Assistant Attorney General and on reasonable notice to any defendant made to its principal office be permitted, subject to any legally recognized privilege, (1) access during the office hours of said defendant, to all books, ledgers, accounts, correspondence, memoranda and other records and documents in the possession or under the control of said defendant relating to any matters contained in this judgment and (2) subject to the reasonable convenience of said defendant and without restraint or interference from it to interview such defendant, or officers or employees thereof, who may have counsel present, regarding any such matters; provided, however, that no information obtained by the means provided in this paragraph shall be divulged by any representative of the Department of Justice to any person other than a duly authorized representative of such Department except in the course of legal proceedings to which the United States is a party for the purpose of securing compliance with this judgment or as otherwise required by law.

X. Jurisdiction of this Court is retained for the purpose of enabling any of the parties to this decree to apply to the Court at any time for such further orders and directions as may be necessary or appropriate for the construction or carrying out of this judgment, for the modification thereof, or the enforcement of compliance therewith and for the punishment of violations thereof. Dated: , 1950.

WALTER J. LA BUY, United States District Judge.

May 16, 1951.

We hereby consent to the entry of the foregoing judgment. For the plaintiff:

H. G. Morison,

Assistant Attorney General.

SIGMUND TIMBERG,

Special Assistant to the Attorney General.

WILLIS L. HOTCHKISS,

Special Assistant to the Attorney General.

HARRY R. TALAN,

Special Attorney.

For the Defendants:

AMERICAN OPTICAL COMPANY,
an association.

AMERICAN OPTICAL COMPANY, a corporation.

By George A. RANNEY, Jr.,

Attorney.